INSIDE: A SPECIAL REPORT ON THE NEW MIDDLE CLASSES IN EMERGING MARKETS

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Stalemate in Israel

Australia's fires from hell

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To the rescue

The trouble with Obama's plan

Print edition February 14th 2009

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Politics this week

Feb 12th 2009
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Tim Geithner unveiled a long-awaited **rescue plan for America's financial system**. The treasury secretary said banks would get more government cash if they need it, the Federal Reserve would expand its lending programme and private investors would be given incentives to buy toxic assets, among other ideas. Stockmarkets reacted by falling sharply, however, as Mr Geithner provided little detail about how the $2.5 trillion plan, much of which was guessed at in advance, would actually work. See article

Congress reached agreement on the Obama administration's **stimulus package**. The plan was supported by just three Republican senators, giving it enough votes to avoid a filibuster. The Republicans maintained their criticism that the plan is too costly. Barack Obama went to Indiana and Florida to drum up support from voters in towns hit hard by the recession. See article

Meg Whitman took her first official step towards running for governor of **California** by creating an exploratory campaign committee. The former chief executive of eBay, a Republican, has promised to take a strong fiscally conservative position on the Golden State's perennial budget woes.

At the centre of an inferno

AFP

More than 180 people died in **Australia's** worst-ever wildfires. Exceptional heat and prolonged drought provided conditions for fires to spread quickly, but some were set deliberately, or relit after being extinguished by firefighters. Kevin Rudd, the prime minister, said those responsible were guilty of "mass murder". See article

Wu Shu-chen, the wife of Chen Shui-bian, **Taiwan's** president until last year, pleaded guilty to charges of money-laundering and forgery. She denied charges of embezzlement. Mr Chen is in jail, also awaiting trial on corruption charges, which he has said are politically motivated.

Light rainfall did little to ease the worst drought to affect **northern China** in 50 years. Six provinces are badly affected, as is more than 40% of the country's wheat land.

At least 27 people died in attacks on three government buildings in Kabul, capital of **Afghanistan**. The Taliban claimed responsibility. The attacks came shortly before a visit by Richard Holbrooke, Barack Obama's envoy to Afghanistan and Pakistan. See article

Pakistan's interior minister admitted that "some part of the conspiracy" leading to last year's terror attack on Mumbai had taken place in Pakistan. Tensions rose between India and Pakistan after the assault; since then, Pakistan has arrested 71 people allegedly linked to the plot.

Several thousand civilians fled fighting in the shrinking patch of northern **Sri Lanka** controlled by the rebel Tamil Tigers. There were continued concerns for an estimated 200,000 civilians believed to be trapped by the fighting. A female suicide-bomber killed at least 29 people close to a refugee area. See article

Ballot initiative

Days before a referendum in which he is seeking to abolish term limits, **Venezuela's** president, Hugo Chávez, reined in some of his more radical supporters. He ordered officials to arrest the leader of a group that has staged attacks against opposition journalists. And seven policemen were arrested on suspicion of attacking a synagogue. Mr Chávez denied opposition claims that he had encouraged anti-Semitism by breaking relations with Israel last month.

Gun battles between drug-gang members and troops left 21 people dead in northern **Mexico**. Meanwhile, the municipal police chief in Cancún and several other people were arrested over the murder of a retired army general, who had been hired to reform the force.

A Latin American study group, including three former presidents and leading writers, called for a debate on **world drug policy**. It said that prohibition had failed, that drug use should be seen as a public-health problem, and that marijuana should be legalised.

In **Colombia** FARC guerrillas were reported to have murdered 17 Amerindians, whom they accused of collaborating with the army near the Ecuadorean border.

Not yet, Netanyahu

Getty Images

Israel's centrist Kadima party, led by Tzipi Livni, seemed to have won the most seats in a general election, getting 28 in the 120-seat Knesset. That pipped Binyamin Netanyahu's right-wing Likud, which got 27. But Mr Netanyahu may still get a majority with a block of allies on the right, whereas Ms Livni, who would be the first female prime minister since Golda Meir, will struggle to form a coalition. The late arrival of soldiers' votes may alter the final tally. A far-right party, Yisrael Beitenu, led by Avigdor Lieberman, won 15 seats, beating the once-dominant Labour Party, which got only 13. See article

Morgan Tsvangirai, the leader of **Zimbabwe's** main opposition party, the Movement for Democratic Change, was sworn in as the country's prime minister. Under a power-sharing deal, Robert Mugabe remains president, but more than half the cabinet posts are shared among opposition parties. America and Britain will not fully resume aid or lift travel bans and financial curbs on Mr Mugabe and his close colleagues until there is evidence that the new government is functioning properly and that Mr Tsvangirai is being allowed to govern. See article

South Africa's stopgap president set a date of April 22nd for a general election.

Glos finished

Germany's economy minister, Michael Glos, resigned. In the first big ministerial shuffle of Angela Merkel's grand-coalition government, he was replaced by Karl-Theodor zu Guttenberg, another member of Mr Glos's Bavarian party, the Christian Social Union. See article

Latvia became the worst-performing economy in the European Union when it announced a fall in GDP in the fourth quarter of 2008 of 10.5% over a year earlier.

The commander of **Azerbaijan's** air force, Lieutenant-General Rail Rzayev, was shot dead by an unknown gunman as he was getting into his car outside his home in Baku.

A Russian **communications satellite** collided with an American one over Siberia, spraying debris through space. It is the first time that two intact spacecraft have accidentally run into each other, according to NASA.

Business this week

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Bankers in America and Britain faced a roasting at hearings in Congress and Parliament. The chief executives of eight banks, including Bank of America, Citigroup and Goldman Sachs, were contrite in their testimony to congressmen, who wanted to know how the public aid that the banks receive is being spent, and when it would be repaid. Politicians in both countries also blasted bankers for continuing to pay out large **bonuses**. See article

Crosby defenestrated

At the parliamentary hearing the former head of risk at **HBOS** said he had been dismissed in 2004 for warning the bank that it was expanding too quickly. The allegation prompted James Crosby, HBOS's chief executive at the time, to resign from his current job as deputy chairman of the Financial Services Authority. The FSA felt compelled to issue a statement that it had raised its own concerns about risk management at HBOS as far back as 2002. See article

UBS posted an annual net loss of SFr19.7 billion ($18.2 billion), the biggest-ever in Swiss corporate history. Net outflows from private clients at the bank's wealth-management division continued apace in the last quarter of 2008. Still, UBS reported that net new money was "positive" in January, and that it expects to turn a profit in 2009.

Barclays, which has not received funding from the British government, made a pre-tax profit of £6.1 billion ($11.9 billion) last year. The bank gained, among other things, from its acquisition of Lehman Brothers' American business.

BNP Paribas's takeover of **Fortis's** Belgian banking operations was thrown into doubt after an angry meeting of Fortis shareholders. They rejected two (already completed) deals crafted by the Belgian and Dutch governments that split Fortis's assets, forcing the abandonment of a third vote on the BNP Paribas acquisition.

The Securities and Exchange Commission reached a deal with **KBR** and **Halliburton**, two engineering contractors based in Houston, that resolves charges relating to the bribery of Nigerian officials. The penalties and fines of $579m constitute the largest combined settlement ever paid by American companies under the Foreign Corrupt Practices Act.

Intel unveiled plans to invest $7 billion in factories in America that will make new, 32-nanometre chips and support 7,000 high-tech jobs.

State returns

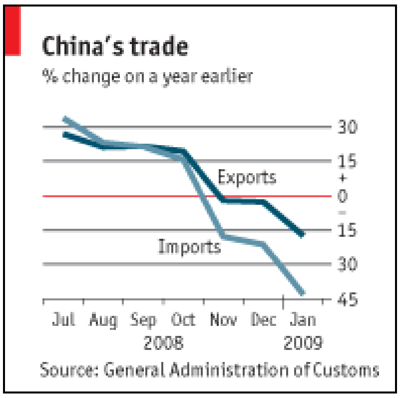
The French government said it would provide separate €3 billion ($3.9 billion) five-year loans to both **Renault** and **PSA Peugeot-Citroën** in return for the companies agreeing to keep factories open in France. Nicolas Sarkozy's suggestion that Peugeot close its plants in other countries caused much consternation in Slovakia and the Czech Republic, where Peugeot has factories. The Czech prime minister accused the French president of protectionism and called a summit.

Nissan forecast a big annual loss, its first since Carlos Ghosn was parachuted in to head the Japanese carmaker when it struck an alliance with Renault, which holds a 44% stake. Nissan will shed 20,000 jobs.

General Motors cut 14% of its salaried workforce, or 10,000 employees, as part of a viability plan that it must soon submit to Congress in order to keep its bail-out money.

China's exports fell by 17.5% in January, compared with a year earlier.
Imports plunged by 43%. The figures were worse than expected. Taiwan,

Japan and South Korea, which supply China with many of the components used in its factories, have all recorded much steeper declines in exports.



Rio Tinto made public the terms of an investment from **Chinalco**. The state-owned Chinese aluminium producer will provide a $19.5 billion injection to the Anglo-Australian mining giant in return for stakes in some of Rio's mining assets and convertible bonds, which could eventually give Chinalco a near-20% stake in Rio. The deal is controversial, not least in Australia, which promptly began re-examining its foreign-ownership laws. See article

Alaska Airlines asked for a public inquiry into **Virgin America's** "citizenship status". Virgin America began regular flights in the United States in August 2007 after three years of wrangling over the status of its foreign ownership. To operate on domestic routes, a carrier must be at least 75% owned by American investors.

Born to run?

Live Nation and **Ticketmaster** announced their long-rumoured merger, which will create a behemoth in the business of promoting concerts and other live events. Antitrust regulators will look closely at the deal. Some artists, including Bruce Springsteen, have complained that they are steadily being given less of a say about their tours.

Economist.com OPINION

KAL's cartoon

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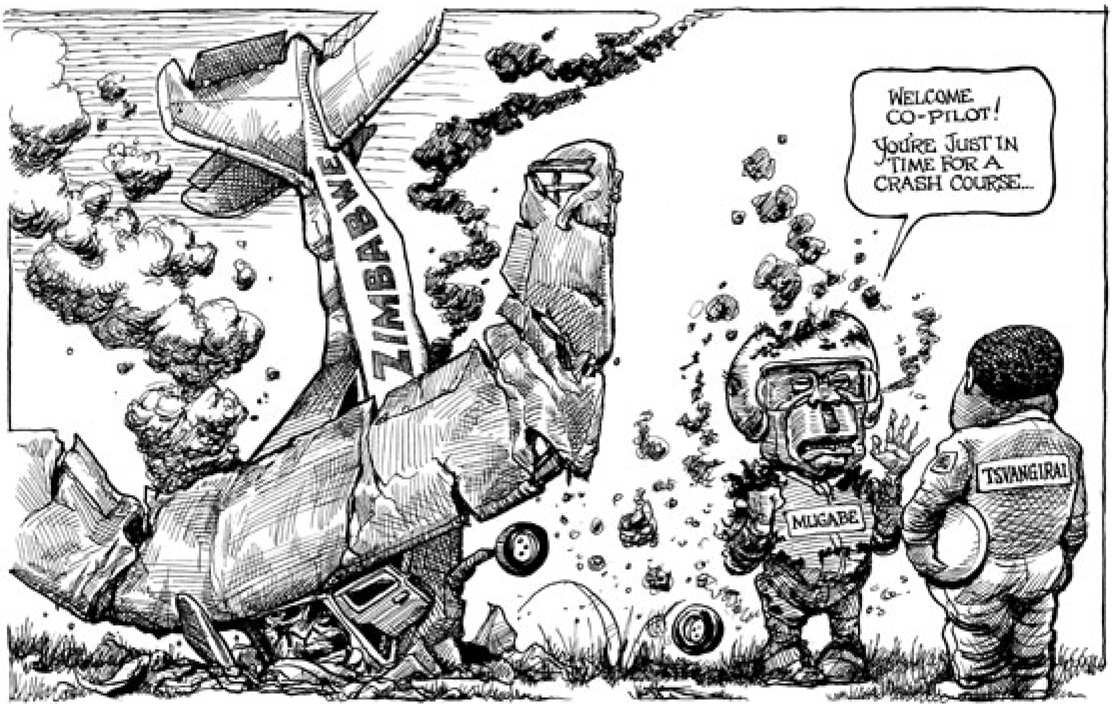
Illustration by KAL



Saving the banks

The Obama rescue

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This week marked a huge wasted opportunity in the economic crisis

Illustration by KAL

THERE was a chance that this week would mark a turning-point in an ever-deepening global slump, as Barack Obama produced the two main parts of his rescue plan. The first, and most argued-over, was a big fiscal boost. After a lot of bickering in Congress a final compromise stimulus bill, worth $789 billion, seemed to have been agreed on February 11th; it should be only days away from becoming law. The second, and more important, part of the rescue was team Obama's scheme for fixing the financial mess, laid out in a speech on February 10th by Tim Geithner, the treasury secretary.

America cannot rescue the world economy alone. But this double offensive by its biggest economy could potentially have broken the spiral of uncertainty and gloom that is gripping investors, producers and consumers across the globe.

Alas, that opportunity was squandered. Mr Obama ceded control of the stimulus to the fractious congressional Democrats, allowing a plan that should have had broad support from both parties to become a divisive partisan battle. More serious still was Mr Geithner's financial-rescue blueprint which, though touted as a bold departure from the incrementalism and uncertainty that had plagued the Bush administration's Wall Street fixes, in fact looked depressingly like his predecessors' efforts: timid, incomplete and short on detail. Despite talk of trillion-dollar sums, stockmarkets tumbled. Far from boosting confidence, Mr Obama seems at sea.

Toxic tantrums, contingent chaos

The fiscal stimulus plan has some obvious flaws. Too much of the boost to demand is backloaded to 2010 and beyond. The compromise bill is larded with spending determined more by Democrat lawmakers' pet projects than by the efficiency with which the economy will be boosted. And it contains "Buy American" clauses that, even in their watered-down version, send the wrong signal to trading partners.

For all those shortcomings, the stimulus plan gets one big thing right. Given the pace at which demand is slumping, a big, and sustained, fiscal boost is vital for America's economy. This package, albeit imperfectly, administers it.

That makes the inadequacy of the financial rescue all the more regrettable. Fiscal stimulus, indispensable

as it is, cannot create a lasting economic recovery in a country with a broken financial system. The lesson of big banking busts, such as Japan's in the 1990s, is that debt-laden balance-sheets must be restructured and troubled banks fixed before real recoveries can take off. History also suggests that countries which address their banking crises quickly and creatively (as Sweden did in the early 1990s) do better than those that dither. This is expensive and painful, but cautious, penny-pinching governments end up paying more than those that tread boldly.

By any recent historical standards America's banking bust is big (see article). The scale of troubled loans and the estimates of likely losses—which are now routinely put at over $2 trillion—suggest many of the country's biggest banks may be insolvent. Their balance-sheets are clogged by hundreds of billions of dollars of "toxic" assets—the illiquid, complex and hard-to-price detritus of the mortgage bust, as well as growing numbers of non-housing loans that are souring thanks to the failing economy. Worse, banks' balance-sheets are only one component of the credit bust. Most of the tightness of credit is owing to the collapse of "securitisation", the packaging and selling of bundles of debts from credit cards to mortgages.

Fixing this mess will require guts, imagination and a lot of taxpayers' money. Mr Geithner claims he knows this. "We believe that the policy response has to be comprehensive and forceful," he declared in his speech, adding that "there is more risk and greater cost in gradualism than aggressive action."

But his deeds did not live up to his words. His to-do list was dispiritingly inadequate on some of the thorniest problems, such as nationalising insolvent banks, dealing with toxic assets and failing mortgages. Mr Geithner promised to "stress-test" the big banks to see if they were adequately capitalised and offer "contingent" capital if they were not. But he offered few details about the terms of public-cash infusions or whether they would, eventually, imply government control. His plan for a "public-private investment fund" to buy toxic assets was vague and its logic—that a nudge from government, in the form of cheap financing, would enliven a moribund market—was heroic. Banks' balance-sheets are clogged with toxic junk precisely because they are unwilling to sell the stuff at prices hedge funds and other private investors are willing to pay. Vagueness, in turn, led to incoherence. How can you stress-test banks if you do not know how their troubled assets will be dealt with and at what price? Amid these shortcomings were some good ideas, such as a fivefold expansion of a $200 billion fledgling Fed facility to boost securitisation. But for nervous investors and worried politicians, desperate for details and prices, the "plan" was a grave disappointment.

A great failure of nerve

How serious is this setback? One interpretation is that Mr Obama's crew mismanaged expectations—that they promised a plan and came up with a concept. If so, that is a big mistake. Managing expectations is part of building confidence and when so much about these rescues is superhumanly complex, it is unforgivable to bungle the easy bit.

More worrying still is the chance that Mr Geithner's vagueness comes from doubt about what to do, a reluctance to take tough decisions, and a timidity about asking Congress for enough cash. That is an alarming prospect. "Banksters" may be loathed everywhere (see article), but more money will surely be needed to clean up America's banks and administer the financial fix the economy needs. That, as this newspaper has argued before, means both some form of "bad bank" for toxic loans (with temporary nationalisation part of that cleansing process, if necessary) and guarantees to cover catastrophic losses in the "good" banks that remain. Mr Obama's team must recognise this or they, like their predecessors, will come to be seen as part of the problem, not the solution.

Economist.com OPINION LEADERS

Bank bonuses

Sound and fury

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The virulent debate over bankers' pay ignores bigger problems—especially governance

Illustration by Claudio Munoz

RAGE can be cathartic and constructive. But the outbreak of anger about bankers' bonuses is muddled and comes too late. The way that many bankers are rewarded needs to change. But bashing the industry about pay oversimplifies one problem and ignores another, deeper one.

That pay has become a touchstone is no surprise. What could better demonstrate the inequities of modern finance than multibillion-dollar rewards for the bankers and IOUs for the taxpayers who have bailed them out? Politicians are not about to pass up an opportunity this golden. American and British bank bosses were hauled up in front of lawmakers on February 10th and 11th to issue scripted apologies for their mistakes and to answer mocking questions about their pay packages. The poor lambs are even being shunned in private: many moan that this year's Davos meeting gave no shelter.

Picking on pay can be tactically useful. Barack Obama's blunt criticism of bonuses that have been awarded for the past year's results and his plans to impose (very soft) pay limits on senior executives at some banks may help to overcome opposition to further bail-outs.

And some of the flak is warranted. Take the proposal by Royal Bank of Scotland, which would have gone belly-up without state funds, to pay out £1 billion ($1.5 billion) in bonuses in spite of losing an expected £28 billion in this fiscal year. Where those bonuses reflect contracts, they must be honoured. Otherwise they should be binned. In any other industry, when a company goes bankrupt, workers lose their bonus whether or not they helped cause their company's downfall. Other practices also need to change. Too many banks set bonus pools as a percentage of revenue, not profit. Too few banks allocate internal capital and funding at rates that properly reflect the risks being taken.

But the hubbub around pay also oversimplifies things, especially by conflating the level of pay with its structure. Bankers' pay during the bubble was too high, just like everything else: fees, office rents, expenses—and profits. Making bankers squirm today is part of the summary justice needed to beat pay down from those extremes. Yet it would be a mistake for the state to impose broad pay caps. In the short run the market is at work: financiers are already earning much less. In the long run caps are dangerously illiberal. Finance relies on individuals. Although "talented bankers" sounds like an oxymoron just now, and the world has too many financiers, employers compete for their skills even in today's market. You don't want regulated "utility" banks to end up with all the worst people.

Bonus question

Better to concentrate on the structure of pay. Award more bonuses in shares and pay them over longer periods. Claw back bonuses that turn out to be earned on excessive risks. Reward exceptional performance, not the rising tide of the markets.

Even this has its limits. Banks already do some things that normally work with pay: they have high variable pay; their senior executives own shares; some now have clawback schemes that adjust bonuses if loans or trading positions go bad. Rules alone do not work; what matters is how they are applied. And that points to the bigger issue—governance.

Shareholders have suffered in the crash, but why didn't they and their boards step in, rather than egg the bankers on? How did the apparatus of risk managers and board committees allow them to err so badly? Britain has initiated a review of bank governance. Others should follow. Such questions may not quench public anger in the same way as a pay-cap would, but they are more likely to yield useful answers.

Economist.com OPINION LEADERS

Israel and the Arabs

Stalemate all around

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All the more reason for Barack Obama to march towards the sound of gunfire

Reuters

FOR reasons of his own, Barack Obama chose to disregard the advice he got from many quarters that he should spell out his views on Palestinian statehood before Israel's voters went to the polls on February 10th. That is a pity. Israelis disagree about many things, but most understand the value of having a prime minister who is liked and welcomed in the White House. Had Mr Obama made it clearer before the election that he is impatient to see Israel withdraw from the bulk of the West Bank and the creation there and in Gaza of an independent Palestinian state, more Israelis might have cast their vote for Tzipi Livni, the leader of Israel's centrist Kadima party. Ms Livni showed as foreign minister during Israel's recent Gaza war that she is no cooing dove. But she appears genuinely to believe not only in the possibility but also in the urgency of negotiating a peace agreement with the Palestinians.

As it is, voters gave Kadima only one seat more than Binyamin Netanyahu's Likud, which thanks to Israel's fractionated political system means that he may yet lead a ruling coalition (see article). And on peace Mr Netanyahu has depressing form. As prime minister in the late 1990s he failed to build on the opening initiated by the assassinated Yitzhak Rabin. In campaigning for this week's election he poured cold water on the idea of a two-state solution, arguing that the moderate Palestinians are for the foreseeable future too weak to be good neighbours if Israel were to pull its soldiers and settlers out of the West Bank. Such a Palestinian state, he says, would swiftly become, like Lebanon under Hizbullah and Gaza under Hamas, another bridgehead from which Iran and its proxies would pursue their ambition to extirpate the Jewish state.

It may now take weeks for Israel to choose a new government. Although Ms Livni would probably make the more amenable interlocutor, Israel's eventual choice is not as decisive as it may seem. For even if Ms Livni becomes prime minister, the road to peace will not be straight. Many obstacles block the way: not just Israel's complicated wants and fears but also, on the Palestinian side, the bitter rift between Fatah and Hamas. By the same token, even if it is Mr Netanyahu who triumphs, Mr Obama must resist the temptation to conclude that the conflict is deadlocked and nothing can be done for now. That is what George Bush did eight years ago, after diplomacy failed and a Palestine *intifada* set Israel and the occupied territories on fire. But the correct lesson from the Bush years is that when there is stalemate in Palestine, or the fire is left untended, things do not remain the same. They get worse.

The most obvious cost of inaction is the leaching away of trust. Many Israelis, bombarded by Hizbullah after withdrawing from Lebanon and by Hamas after withdrawing from the Gaza Strip, no longer believe in the old formula of land for peace: it has been more like land for war, they say. Many Palestinians, likewise, have lost faith in what they consider the lip service Israel pays to a two-state solution. How can Israel expect to be taken seriously, they ask, when even under left or centrist parties, such as Labour or

Kadima, every single Israeli government extends and fortifies the Jewish settlements inside the West Bank, in territory that ought in justice and logic to be the preserve of the long-promised Palestinian state?

As relations between Israelis and Palestinians deteriorate, so does the state of the respective societies. The rise of Avigdor Lieberman's party in Israel reflects a fraying of cohesion as Arab Israelis identify more with the Palestinian cause and Jewish Israelis come to see Arabs as fifth-columnists. Across the line in Palestinian society the schism between Fatah and Hamas has meanwhile grown increasingly violent, a competition for power and ideas mirrored in its turn by a wider split between the "resistance" block of Iran and Syria and a pro-American camp led by Egypt, Jordan and Saudi Arabia. Israel tends to exaggerate for American consumption the extent to which Iran is the puppet master of Hamas and Hizbullah. But Iran has indeed exploited the Palestinian cause in its bigger competition with America for dominance of the region as a whole.

Time to speak out, Mr President

However unripe the present conditions seem, it would therefore be folly for Mr Obama to adopt Mr Bush's semi-detached approach to Palestine. Justly or not, America's stance on this conflict is now entangled in its own interests and alliances in the Middle East and the wider Muslim world. The new president has made a good start by appointing the fair-minded George Mitchell as a special envoy to the region, but this is not enough (see article). It would strengthen moderates in both camps if he gave his personal imprimatur to the two-state "parameters" laid out at the beginning of the decade by Bill Clinton, and mobilised international support for them.

Mr Obama should also exert whatever pressure is needed to make Israel freeze settlement in the West Bank. That will be a vital test of his own seriousness as well as Israel's good faith. The settlements are by no means the only obstacle to a two-state solution. Mr Netanyahu is right to finger Hamas and Iran as determined spoilers. But all the actions outlined here would have the effect of bolstering the moderates and making the job of the spoilers harder, increasing the likelihood that Hamas too will eventually be forced by its own people to accept the logic of two states. Drift and inaction have done more than anything to strengthen the rejectionists this past decade.

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Electronic books and newspapers

An iTunes moment?

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The growing popularity of electronic books could offer hope for newspapers

Getty Images

THINGS are suddenly hotting up in the rather obscure field of electronic books and their associated reading devices, the best known of which is Amazon's Kindle. A new, sleeker version of the Kindle was unveiled on February 9th. Just days earlier, Google said it was making 1.5m free e-books available in a format suitable for smart-phones, such as Apple's iPhone and handsets powered by Google's Android software. Amazon said it was working to make e-books available on smart-phones as well as the Kindle. Plastic Logic, the maker of a forthcoming e-reader device, said it had struck distribution deals with several magazines and newspapers. The iPhone, meanwhile, has quietly become the most widely used e-book reader: more people have downloaded e-book software (such as Stanza, eReader and Classics) for iPhones than have bought Kindles. Might e-books be approaching the moment of take-off, akin to Apple's launch of the iTunes store in 2003, which created a new market for legal music downloads?

The analogy is informative, and not just because the Kindle is often described as "the iPod of books". Before Apple moved into music downloads, consumers faced a bewildering array of incompatible and incomplete services, none of which had critical mass, thanks in part to the record companies' inability to agree on a common format. Apple, not being a record company, was able to broker an agreement and define a standard. At first, there was widespread scepticism that anyone would pay for music downloads, given rampant piracy of music on the internet. But being able to find music quickly and easily, rather than fiddling around with file-sharing software, proved far more popular than expected, and iTunes took off. That has not stopped piracy, and download revenues have not been anywhere near enough to compensate for falling CD sales. But iTunes provided a new model for a troubled industry.

Book publishers are in better shape than record labels. Far from harming sales, the Kindle and the iPhone seem to offer incremental revenue, by making it easier for avid readers to buy more titles. Yet if e-readers do take off, the real beneficiaries could be the ailing newspaper and magazine publishers.

The print media are in an awful state—and not just because advertising revenue always dives in recessions. Thanks to the rise of the internet, much of their business, notably classified ads, is migrating rapidly to the web. Meanwhile, most have failed to find a decent online business model. Giving news away on the internet, as most newspapers do, and selling online advertising alongside it, is not sustainable because the ad rates are so much lower online. Attempts to charge subscription fees or set up "micropayment" schemes have failed.

But consumers treat phones (and Kindles) differently from PCs. People pay for text messages, even though e-mail is free. Apple has sold millions of iPhone applications through the iTunes store. Several newspapers and magazines are already available, by subscription, to Kindle users. As with iTunes, people

are happy to pay once it is made easy.

So it is not unreasonable to suppose that someone could step in, as Apple did with music, and introduce a comprehensive and easy-to-use shopfront, through which books, newspapers and magazines could be supplied to paying customers. The convenience of having content delivered to devices automatically overnight, and being able to flick quickly between stories at the breakfast table, when underground or on an aeroplane, might be something that people will pay for. If this approach took off, newspapers would no longer depend on advertisers and could wind down their paper editions. (They could also quietly scale back their free websites.)

How Apple could kill the Kindle

Amazon clearly has designs on this market with the Kindle, even though it is primarily intended for reading e-books. But Apple is arguably in a much stronger position. There are already millions of iPhones and touch-screen iPods in circulation, and the company has long been rumoured to be working on a larger “tablet” device. Selling e-books and newspapers via iTunes, which already has millions of paying customers, would be simple. True, Steve Jobs, Apple’s mercurial boss, has expressed scepticism about e-readers, claiming that “people don’t read any more”. But Mr Jobs has a record of insisting that Apple is not interested in making a particular product (a video iPod, a mobile phone)—right up until the moment when he unveils one. Might e-books soon be the next example?

The Balkans

A year in the life of Kosovo

Feb 12th 2009
From The Economist print edition

The prospect of European Union membership is the only real guarantee of stability in the western Balkans

ON FEBRUARY 17th Kosovo will mark the first anniversary of its unilateral declaration of independence from Serbia. Doubtless Kosovo's mostly ethnic-Albanian population will celebrate happily and noisily. Yet thanks to Russian obstruction of any new United Nations resolution on Kosovo's status, its independence remains highly controversial. The new country has so far been recognised by only 54 of the UN's 192 countries—and five of the 27 members in the European Union are among the refuseniks.

Even so, the many critics who predicted gloomily that Kosovo's unilateral independence would inevitably trigger fresh outbreaks of violence and ethnic cleansing, a wave of uncontrolled emigration, drug- and people-smuggling, a nasty upsurge in Serb nationalism and perhaps even a renewal of war in the Balkans have been proved wrong. Today Kosovo is largely peaceful, if poor. Its Serb minority and their religious sites are protected by NATO troops. The EU's biggest foreign mission of policemen, judges and customs officials, known as EULEX, has been successfully scattered across the country, including its Serb-populated areas. And, although Serbia still refuses to accept Kosovo's independence, it now has the most pro-EU government in its history.

As for the dire warnings that Kosovo's independence would set a dreadful precedent for other restive regions, it was entirely predictable that the Russians would cite it as an example during their war with Georgia last August, after which they hastily recognised the independence of the two breakaway Georgian territories of Abkhazia and South Ossetia. But in reality this was no more than a debating point. Nobody seriously believes that, had Kosovo still been a province of Serbia, Russia would not have gone to war with Georgia. And Russian recognition of the two Georgian territories has been followed by precisely one other country, Nicaragua—with, mercifully, little sign of any others to come.

All the same, Kosovo's position remains insecure. It would get a big boost if the five EU countries that have not yet recognised it—Spain, Greece, Romania, Slovakia and Cyprus—changed their minds, as a recent European Parliament resolution strongly recommends. These countries have understandable misgivings about their own border disputes or rebellious regions. But they know that they will have to recognise Kosovo one day. The longer they postpone the decision to do so, the more they help to foster an impression of European disunity that is bad for Kosovo and the rest of the western Balkans—and, indeed, for the EU itself.

From Belgrade to Brussels

The truth is that all countries in the western Balkans are in some degree of trouble at the moment (see article). Everywhere the global economic crisis is hitting hard, with foreign investment and remittances falling and unemployment rising. Croatia, which is the nearest to joining the EU, has suddenly got bogged down in a niggling border dispute with Slovenia. Macedonia is no closer to settling its longstanding squabble with Greece over its name. Bosnia has just lost its international proconsul, and its two main entities remain at loggerheads. And hopes in Serbia that its oft-postponed stabilisation agreement with the EU might come into force soon have foundered on opposition inside the union: the Dutch (and Belgians) insist that the Serbs should first find and deliver to The Hague war-crimes tribunal Ratko Mladic, the Bosnian Serb general accused of committing genocide at Srebrenica.

A common thread can be traced here. The Balkans may not be in the international headlines as much as in the 1990s, but the underlying tensions and atavistic nationalism that helped to ignite several regional wars after the break-up of the former Yugoslavia remain. Admittedly, there is no serious appetite for a

new war in the Balkans, even among the most radical Serb nationalists. But the danger of violence and political instability is still high—and it holds back the whole region by making it less appealing to investors.

As most analysts in both the Balkans and Brussels have long recognised, the best solution to this is to put all countries in the western Balkans securely on the path towards EU membership. It is ultimately only the lure of the EU that has held a divided Bosnia together and pushed a reluctant Serbia into greater co-operation with The Hague tribunal, for instance. Accordingly the EU must keep open the door to future membership. Only then can it be sure of a peaceful and happy future for both Kosovo and the rest of the western Balkans.

The middle class in emerging markets

Two billion more bourgeois

Feb 12th 2009
From The Economist print edition

The rise of a new middle class has changed the world. What if they sink back into poverty?

Illustration by Brett Ryder

PEOPLE love to mock the middle class. Its narrow-mindedness, complacency and conformism are the mother lode of material for sitcom writers and novelists. But Marx thought “the bourgeoisie…has played a most revolutionary part” in history. And although *The Economist* rarely sees eye to eye with the father of communism, on this Marx was right.

During the past 15 years a new middle class has sprung up in emerging markets, producing a silent revolution in human affairs—a revolution of wealth-creation and new aspirations. The change has been silent because its beneficiaries have gone about transforming countries unobtrusively while enjoying the fruits of success. But that success has been a product of growth. As growth collapses, the way the new middle class reacts to the thwarting of its expectations could change history in a direction that is still impossible to foresee.

The new middle consists of people with about a third of their income left for discretionary spending after providing basic food and shelter. They are neither rich, inheriting enough to escape the struggle for existence, nor poor, living from hand to mouth, or season to season. One of their most important characteristics is variety: middle-class people vary hugely by background, profession and income. As our special report in this week’s issue argues, their numbers do not grow gently, shadowing economic growth and rising 2%, or 5%, or 10% a year. At some point, they surge. That happened in China about ten years ago. It is happening in India now. In emerging markets as a whole, it has propelled the middle class from a third of the developing world’s population in 1990 to over half today. The developing world is no longer simply poor.

As people emerge into the middle class, they do not merely create a new market. They think and behave differently. They are more open-minded, more concerned about their children’s future, more influenced by abstract values than traditional mores. In the words of David Riesman, an American sociologist, their minds work like radar, taking in signals from near and far, not like a gyroscope, pivoting on a point. Ideologically they lean towards free markets and democracy, which tend to be better than other systems at balancing out varied and conflicting interests. A poll we commissioned for our special report on the middle class in the developing world finds that such people are happier, more optimistic and more supportive of democracy than are the poor.

These attitudes transform countries and economies. The middle class is more likely to invest in new products and new technologies than the rich, who tend to defend their existing assets. It is better able than the poor to leap barriers to entry into business and can therefore set up companies big enough to generate jobs. With its aspirations and capacity for delayed gratification, the middle class is more likely to invest in education and other sources of human capital, which are vital to prosperity. For years,

policymakers have tied economic success to the rich ("trickle-down economics") and to the poor ("inclusive growth"). But it is the middle class that is the real motor of economic growth.

Now the middle class everywhere is under a great threat. Its members have flourished in places and countries that have opened up to the world economy—the eastern seaboard of China, southern India, metropolitan Brazil. They are products of globalisation, and as globalisation goes into reverse they may well be hit harder than the rich or poor. They work in export industries, so their jobs are unsafe. They have started to borrow, so are hurt by the credit crunch. They have houses and shares, so their wealth is diminished by falling asset prices.

What will they do when the music stops?

Those at the bottom of the ladder do not have far to fall. But what happens if you have clambered up a few rungs, joined the new middle class and now face the prospect of slipping back into poverty? History suggests middle-class people can behave in radically different ways. The rising middle class of 19th-century Britain agitated peacefully for the vote; in Latin America in the 1990s the same sorts of people backed democracy. Yet the middle class also supported fascist governments in Europe in the 1930s and initially backed military juntas in Latin America in the 1980s.

Nobody can be sure what direction today's new bourgeoisie of some 2.5 billion people will take if its aspirations are dashed. If the downturn lasts only a year or two the attitudes of such people may survive the pain of retrenchment. But a prolonged crash might well undo much of the progress the developing world has lately made towards democracy and political stability. It is hard to imagine the stakes being higher.

Economist.com OPINION LETTERS

On Thailand, finance, senators, Russia, east Europeans, the economic crisis, Norway, taxpayers, Martha's Vineyard

Feb 12th 2009
From The Economist print edition

Thailand and the Rohingya

SIR – I would like to respond to your leader on Thailand's "disgraceful treatment of refugees" ("A sad slide backwards", January 31st). Thailand has had to deal with flows of people from neighbouring countries for more than 40 years now and it has stood firm by its humanitarian tradition throughout. Upholding basic human rights is a guiding principle for Thai policy and like other countries Thailand protects its borders and citizens in accordance with its immigration laws and applicable international law.

The Rohingya issue is complex; these migrants number several thousand each year and are a security concern for Thailand and other countries in the region. We have proposed forming a contact group among countries of origin, transit and destination to find solutions to this problem. Together we will work to combat the human-smuggling rings that invite the migrants to undertake perilous journeys across the seas, and to urge international organisations such as UNHCR and the International Organisation for Migration to mobilise the international community's resources to improve the livelihood of the Rohingya.

On the reported abuse against illegal Rohingya migrants, Abhisit Vejjajiva, the Thai prime minister, has clearly stated that those found to have violated human rights as alleged will be held accountable. So you should not prejudge an outcome based on your presumptions about the prime minister's supposed "dependence on the generals". As you are very well aware, Mr Abhisit has come to power by parliamentary means. Finally, the Thai monarchy has not involved itself in politics nor backed any political group or movement. *The Economist* therefore should not overstate the case on its role.

Tharit Charungvat
Director-general
Department of information
Ministry of Foreign Affairs
Bangkok

Principles of finance

SIR – Your special report on the future of finance (January 24th) glossed over the fact that responsible people and responsible institutions have not hurled themselves, lemming-like, into the abyss of ruin. Despite the death knell sounded throughout the media, most people and most banks did not encumber themselves with mountains of unsecured debt. In the conservative heartland of America we have avoided the razzle-dazzle of "sophistication" and "computer-modelling" when managing our finances.

I have entrusted a locally owned bank in Kansas City with my money for more than 40 years, and it has been a good steward of my modest wealth. Last year the chief executive posted a brief notice on the bank's website to reassure depositors. It read, "When the siren song of the subprime-mortgage market came along we took the long view and turned a deaf ear." I am going to leave my money with the folks at this bank for the next 40 years, for they seem to have the intelligence and common sense largely absent in the leadership of large banks.

Frederick Holmes
Professor of medicine emeritus
University of Kansas
Kansas City, Kansas

SIR – I am surprised that your list of hypotheses on the causes of speculative booms did not include the theory of the business cycle first described by Ludwig von Mises and later elaborated by Friedrich von

Hayek. According to this theory it is the artificial lowering of interest rates and creation of excess credit by a central bank's monetary policy that causes investors to erroneously believe that economic conditions are better than they actually are, leading to an abundance of overconfidence. The excess amount of easy money causes prices of assets such as equities or property to increase, which reinforces speculative tendencies. A central banker's manipulation of the price of money, ie, interest rates, is no more sound economic policy than any other form of central government planning.

Richard Schwartz
Cleveland, Ohio

SIR – We absolutely should not "remember the remarkable prosperity of the past 25 years." You just don't get it. This so-called "prosperity" was based on a financial bubble, and it has now burst. Finance must be reined in like a runaway ass, or we will remain in this hole.

Azmat Malik
Hillsborough, California

Balancing power in America

SIR – You maintain that it is time to curb the power of governors to appoint someone to a vacant seat in the Senate ("Over-mighty governors", January 31st). The alternative is the immediate election of a new senator by voters, for which the federal constitution would need to be amended. But should a national solution be imposed on all the states to remedy, for example, Rod Blagojevich's errant ways in Illinois or David Paterson's flawed judgment in New York?

State politicians should continue to have the authority to decide for or against an immediate election. They may think the risk of misconduct by a governor when appointing a senator merits a ballot. Or they might reasonably decide against spending money on an election that will probably be marked by low turnout and an inadequate consideration of the candidates. It would be a mistake to deprive the states of yet another power in a federalist system already tilted too heavily towards Washington.

John Samples
Director
Centre for Representative Government
Cato Institute
Washington, DC

A Kremlin watcher

SIR – Russia's hint that it might not station short-range missiles at Kaliningrad after all is, you think, "good news" ("Cool heads", January 31st). Actually, for all of Vladimir Putin's and Dmitry Medvedev's bluster over deploying the missiles, Russia's ability to pay for the weapons, maintain bases for them and support highly trained crews is severely hampered with oil at $40 a barrel. Abandoning the plan is necessary if Russia wants to keep its present military paid and equipped. Messrs Putin and Medvedev may therefore be trying to turn a potential military and financial embarrassment into a possible foreign-policy coup.

Dennis Burke
Berkeley, California

A picture worth 163 words

SIR – Given your newspaper's determination to accompany any article on social or political affairs in eastern Europe with a photograph of the apparently ubiquitous old lady with a shawl wrapped over her head, I was delighted to find that your recent piece on the gas crisis in the region ("Gasping for gas", January 17th) carried a picture representative of another important demographic group: the dentally challenged villager. My excitement was short-lived, however, as just a week later it was back to the well-wrapped old lady ("To the barricades", January 24th). One gets the impression from your coverage of elections that every polling station east of the Danube is populated solely by such characters.

To avoid creating any misleading stereotypes, may I suggest that you widen your range of imagery to better represent east Europeans. Roma using horse-drawn carts on main roads, elderly veterans in Soviet-style uniforms and furry hats and vodka-soaked vagrants would broaden the picture.

Daniel Tilles
Cracow, Poland

The following letters appear online only

More principles of finance

SIR – Your special report on the future of finance includes a curious quote by Raghuram Rajan, a professor at the University of Chicago. He argues that mortgage originators would be better served by relying upon judgmental data, such as the "firmness of someone's handshake or the fixity of their gaze," rather than credit scores or loan-to-value ratios for underwriting.

In all deference to Professor Rajan, exhaustive empirical research shows that automated underwriting in consumer mortgages outperforms pure manual underwriting, both in terms of loan portfolio performance and in fairness in lending. Judgmental and automated approaches are not mutually exclusive. Indeed, had mortgage brokers and loan officers relied more upon both approaches when assessing the "3Cs" of credit-character, capacity, and capital, as they will need to in the future, we may have avoided at least some of our present mess.

Michael Turner
President
PERC
Chapel Hill, North Carolina

Thomas Quinn
Vice-president
FairIssac Corporation
San Rafael, California

SIR – Consider that the financial system floundered because Fannie Mae and Freddie Mac, protected by the American government with tax exemptions and financing, could, and did, take on more risk than is normal in the housing-finance industry. Their enhanced propensity for risk forced the wholly private banks to try to compete by matching their bravado and eschewing more prudent lending practices. The academics and bureaucrats who have long pointed out the dangers of such government-sponsored enterprises (which include British quangos) have been vindicated at last. Whoopee.

Rae Andr
Professor of organisational behaviour and design
Northeastern University
Boston

The mess we're in

SIR – Olivier Blanchard set out some useful principles for policymakers (Economics focus, January 31st). When economic historians look back at the present crisis, they might well conclude that by early 2009 there was no longer any doubt:

"World trade was nosediving, unwanted inventories were accumulating everywhere, and homeowners, from Copenhagen to Manchester to Orange county, were losing their property and their hard-earned savings. With total losses from stockmarkets and falling house-prices already in the trillions, it was certain that the retrenchment process would be protracted and require several years before the balance sheets of wage earners, entrepreneurs and retirees would be restored to anything near normality. The perspective of several years of falling output and sharp rises in unemployment should have been a clear warning that forceful, innovative, and urgent measures were required. At this point, there would still have been time to limit the damage. In the event, it was too little and too late—the lessons from the first Depression had not been learnt."

Beyond the removal of worthless derivatives to restore the health of the financial system, there is a critical need to prevent people from losing their homes and thereby moderate the drop in house prices, one of the key reasons why the downturn is likely to deepen and persist well beyond 2009.

It wouldn't be that difficult to imagine that a government agency could purchase distressed mortgages at a fire-sale price, and then allow the homeowner to reimburse the mortgage over the next 30 years at an affordable interest rate. Among the fiscal measures required, meaningful support for consumers' buying power through cuts in VAT seem particularly urgent. Finally, that protectionism would be lethal under current circumstances is obvious to anyone with a sense for economic history, but cannot be repeated too often.

Flemming Larsen
Former deputy-director of research, IMF
La Cadière-d'Azur, France

Norway's wrong choices

SIR – Your briefing on Norway's environmental policies discussed its strategy of offsetting domestic emissions by paying developing nations to stop deforestation ("Binge and purge", January 24th). If the analysis of the Intergovernmental Panel on Climate Change is correct this would reduce food production, as subsistence and commercial agriculture account for around 75% of tropical-forest removals.

Norway's strategy would give the world's poor green food-stamps instead of food. The IPCC also advises that expanding sustainable forestry in developing countries is a more effective way to preserve forests, sustain livelihoods and reduce emission, things the poor would probably prefer.

Alan Oxley
Chairman
World Growth
Arlington, Virginia

SIR – Norway wants to be regarded as a model for good environmental policy, but it has failed miserably to manage its salmon resources. The Norwegian coast is now the world's most dangerous place for salmon, which are disappearing from more and more Norwegian rivers while the government ignores warnings to take the action necessary to restore stocks before it is too late. Norway continues also to support mixed-stock netting that intercepts salmon native to Russia, Finland and Sweden.

There is no salmon leadership in Norway. Almost every other country in the North Atlantic region has made a priority of halting the decline in salmon stocks.

Orri Vigfusson
North Atlantic Salmon Fund
Reykjavik

A growing rebellion

SIR – If anyone thinks that taxpayers will "ante up" to pay for the pensions of a state's public employees they are in for a rude awakening ("The land of liabilities", January 24th). It isn't that state pension-funds are often mismanaged, or that legislatures have squandered surpluses on pet projects, or even that Illinois, California and others have gold-plated their employees' retirement benefits to ensure political support. The more fundamental objection is the outrage of asking your average income-earner with a gutted 401(k) plan to subsidise a comfortable, worry-free retirement for a state worker.

As the United States confronts the many grim implications of its financial disaster, the legal fiction that state workers have an irrevocable claim on benefits that irresponsible politicians have bestowed upon them will become expendable. There is nothing more American than a tax revolt.

Paul Fraker
Lovettsville, Virginia

Odd comparisons

SIR – I was fascinated to learn that Lampedusa in Italy is “a tenth the size of Martha’s Vineyard” (“Trouble with figures”, January 31st). For readers who reside in New England and are privileged enough to take their vacations on the island, this is an invaluable comparison. Why not make it a standard in your newspaper? I’m sure I’m not the only person who would like to know, for instance, that the Isle of Wight is 1.6 times bigger than Martha’s Vineyard, Taiwan 154 times bigger and Iceland 444 times bigger. Far better than boring old imperial or metric measurements.

Paul Rodgers
London

America and Israel

Will the relationship change? Yes it can

Feb 12th 2009 | WASHINGTON, DC
From The Economist print edition

Israel and the Palestinians seem stuck in a poisonous morass, as Israeli voters shift to the right. President Barack Obama has a chance of hauling them out of it

AP

AT FIRST glance, the chances of peace between Arabs and Jews in the Holy Land look dimmer than ever. If Binyamin Netanyahu ends up as prime minister (see article), Israel's voters will have elected a man who, on paper at least, is unwilling to let the Palestinians have anything more in the way of a state than a hollowed-out Swiss cheese of feebly linked cantons. He says the moderate Palestinians are too weak to control the West Bank and need to be strengthened, under Israeli supervision, before any more territory can be handed over to them.

Moreover, even if the centrist Tzipi Livni wins the day, with her support for talks leading to two states living peacefully side by side, the Palestinians are for the moment so sour and so divided that they have no government or leader strong enough to cut a deal and make it work. In any event, after Israel's ferocious assault on the Gaza Strip in December and January, there is no certainty that the current ceasefire will hold with the Islamists of Hamas, which still rules that territory despite its pasting.

Yet hope persists, in part because Barack Obama has a chance of making American policy more even-handed and more effective, after eight years mostly wasted by George Bush and, before that, another eight years in which Bill Clinton tried but failed, to bring the two sides together. More even-handed means more sympathetic to Palestinians. But it also means more security, in the long run, for Israel.

True, nothing spectacular is likely to happen for months. For one thing, an Israeli government could take weeks or more to emerge, and could then prove hobbled by religious and other clamps. For another, Mr Obama, who sees the American economy as his priority, has yet to acquire his own Middle East team, let alone policy, under the dual aegis of Hillary Clinton as his secretary of state and George Mitchell as his special envoy. Besides, not just the Palestinians but also the Arabs and the wider region are in diplomatic disarray.

Many of those Americans urging Mr Obama to take a new approach towards Iran, for instance, admit that little of substance

is likely to alter until after Iran's presidential election in June, when the erratic Mahmoud Ahmadinejad may—or may not—be ousted (see article). Iran, by the by, still eggs Hamas on to make negotiations with Israel difficult if not impossible.

Syria is more promising. Even Mr Netanyahu, if he succeeds in forming a government, is likely to respond favourably to American suggestions that he continue the efforts of his predecessor, Ehud Olmert of the Kadima party, led now by Ms Livni, to negotiate a deal with Syria, whereby Israel would give up the Golan Heights in return for a peace treaty similar to those already signed with Jordan and Egypt. Opening a "Syrian track" is widely considered, by the new policymakers in Washington, to be a good idea. But an Israeli deal with Syria alone is no substitute for negotiations over the nub of the matter: a direct deal between Israel and the Palestinians.

Mr Obama faces three early tests. The first, and perhaps the easiest, is to spell out his vision of a Palestinian state. Its outlines are well known and have been more or less agreed by sensible Palestinians and Israelis, including those in power, for the past decade. Israel would return to the armistice line that existed before the 1967 war, with minor adjustments and territorial swaps of equal size and quality, and would probably keep the three biggest Jewish settlement blocks that bulge out from the 1967 line. Jerusalem would be tortuously but fastidiously divided, allowing each side to have its capital there, with international oversight of the holy places. Palestinians would be granted a symbolic right for their refugees to return on the understanding that only a small and carefully calculated proportion of them would actually do so. Palestine would be sovereign but demilitarised, with an international force, perhaps led by NATO, securing its borders, both along the Jordan valley and maybe between Gaza and Egypt. A road-and-rail link, internationally monitored, might well connect the 50km (30 miles) or so between Gaza and the West Bank.

Mr Olmert himself recently announced, soon after his decision to leave office amid corruption allegations, his wholehearted adoption of the broad package described above. In particular, he mentioned a need to give back "all or nearly all" of the occupied territories and to let the Palestinians have their capital in Jerusalem, on its east side. The clear support of Mr Obama would bolster the region's many moderates and put recalcitrant Israelis and Palestinians alike on the spot.

The president's second big test, widely mooted, will be to warn the Israelis that further expansion of the Jewish settlements on the West Bank, either by extension of boundaries or "natural growth", is totally unacceptable—and will have painful repercussions if it goes on. It is unlikely, in the short run, that an American president, even Mr Obama, would have the nerve to cut military or other aid to Israel in a hurry. The only president to have threatened to do so was George Bush senior, in 1991, when he said he would withhold guarantees on loans. Since then, every Israeli leader has continued to allow settlement expansion, in contravention of international law, without a serious American reaction.

In a recent article in *Newsweek* one of Mr Bush's advisers on Israel-Palestine, Aaron Miller, made a rueful confession:

> In 25 years of working on this issue for six secretaries of state, I can't recall one meeting where we had a serious discussion with an Israeli prime minister about the damage that settlement activity—including land confiscation, bypass roads and housing demolitions—does to the peacemaking process. There is a need to impose some accountability. And this can only come from the president. But Obama should make it clear that America will not lend its auspices to a peacemaking process in which the actions of either side wilfully undermine the chances of an agreement America is trying to broker. No process at all would be better than a dishonest one that hurts America's credibility.

Cutting aid is not the only lever Mr Obama has for jolting Israel into acquiescence over the settlements. Louder verbal expressions of dismay than any of his predecessors have made would be one more. Letting Israel know that the United States cannot any longer be certain to veto finger-wagging resolutions at the United Nations would be another.

Drawing in Hamas

But Mr Obama's hardest test of diplomacy will be drawing Hamas, directly or indirectly, into negotiations. As things stand, Hamas remains excluded because it has refused to meet three laid-in-concrete conditions: a disavowal of terrorism; accepting Israel's right to exist; and going along with previous agreements signed by the Palestine Liberation Organisation (PLO), the nationalist umbrella group to which Hamas does not belong, which would imply acceptance of a two-state solution. Mr Obama during his election campaign and Mrs Clinton since her appointment as secretary of state have reiterated those conditions. Yet a growing body of fixers trying to solve the Israel-Palestine problem, including many Americans in the Obama camp, now think Hamas must be involved, while at the same time knowing that Hamas is certain not to meet those three conditions unambiguously or straight away.

On paper, Hamas rejects Israel's existence outright. Its charter, which contains anti-Semitic slurs and slanders, seeks to establish *sharia* law on all the territory of mandated Palestine, between the Jordan river and the Mediterranean. It glories in martyrdom. Since 1993, and especially during the second Palestinian *intifada* (uprising) from 2001 to 2004, it has carried out more than 100 suicide attacks on Israeli civilians, killing at least 400. It has sanctioned the firing of rockets, though mostly home-made and rarely lethal, at Israeli towns across from Gaza. It reviles its secular rival, Fatah, for its supposed treachery in accepting the Jewish state and the principle of Palestine's partition.

But Hamas is probably indispensable if there is to be a breakthrough towards negotiation. For one thing, it may well be the most popular Palestinian group (see table to the left). It won the last general election in the Palestinian territories fair and square, with nearly 44% of the votes to Fatah's 41%, getting a big majority of seats in the Palestinian parliament. And it still controls Gaza, despite its recent pummelling by the Israelis and despite a blockade and economic sanctions that have lasted intermittently for more than three years. Hamas says it would stop firing rockets, at least for a period, if the blockade were lifted.

In any event, Hamas is more pragmatic than its charter suggests. In conversations with various Western notables, including former President Jimmy Carter and a former head of the American Jewish Congress, Henry Siegman, and in articles in the Western press (in the *Guardian*, the *Washington Post* and elsewhere), its two most prominent leaders, Khaled Meshaal, its secretary-general, and Ismail Haniyeh, its prime minister, have edged towards meeting that trio of conditions.

They state that Hamas would accept Israel "as a reality" if it withdrew to the 1967 boundary and if the Palestinian people accepted the terms of a final deal in a referendum. Hamas would also agree to a *hudna*, a ceasefire plus a political engagement, which—depending on circumstances and on whom in Hamas you talk to—could be 18 months, ten years, or even 50.

Plainly, differences rumble within in Hamas. Its leadership is scattered, with Mr Meshaal in Damascus, Mr Haniyeh in Gaza and nearly all those elected to parliament and resident in the West Bank now in Israeli prisons. Some of the religious zealots may well believe in the obnoxious charter. Others, including Messrs Meshaal and Haniyeh, try to brush it off and then, if pressed, dangle it as an item for negotiation, much as Fatah used the dropping of the PLO's charter, which equally rejected Israel's existence, as a bargaining tool.

AP

Most Palestinians who voted for Hamas also, judging by a raft of opinion polls, actually support the notion of two states. Hamas's popularity is based not on its call for Israel's annihilation, but on its

reputation for honesty in contrast to Fatah's for corruption, on its determination to fight against Israel and on Fatah's failure, so far, to win a state by negotiation. Most Palestinians still want unity between Fatah and Hamas so that a broad government can prise a state out of Israel's hands, on the West Bank and Gaza.


A flag that can't be ignored

Nearly two years ago, at Mecca, the two groups did sign a short-lived unity accord. Hamas agreed, among other things, to "respect" previous PLO agreements, which implied an acceptance of Israel via a two-state solution, though the precise wording later got tangled up in angry semantics: did respect mean accept, and so on? In any event, a few months later, when Fatah was poised militarily to unseat Hamas from its control of Gaza, the Islamists—as they explain it—launched a pre-emptive coup, since when they have kept Fatah, often ruthlessly, out of power in the Strip.

There is little doubt that Mr Mitchell will seek to draw Hamas in. He learnt, during his successful peace-broking in Northern Ireland in 1995-98, that groups such as the Irish Republican Army could not be expected to meet preconditions, such as a definitive disavowal of violence, if an eventual peace was to be achieved. It would be astonishing if he did not apply similar logic—though necessarily, at this stage, in private—in dealing with Hamas. Britain's Tony Blair, who as prime minister worked closely with Mr Mitchell for peace in Northern Ireland, may become more active as an international envoy for peace in Israel-Palestine. It is increasingly clear that no deal in that case will stick if only one half of the Palestinian movement is involved.

From AIPAC to J Street

In mainstream American politics, especially Jewish-American circles, the idea of talking to Hamas has been virtually taboo. This is no longer true. After Mr Obama's election, a group of senior bipartisan foreign-policy veterans handed a compelling letter, still unpublished, to the incoming president. Its signatories included Zbigniew Brzezinski and Brent Scowcroft, who headed the National Security Council in Mr Carter's and George Bush senior's White House; Lee Hamilton, a Democrat who for many years chaired the House committees on foreign affairs and intelligence; Sam Nunn, a Democrat who chaired the Senate's armed services committee; Paul Volcker, a long-time chairman of the Federal Reserve; Mr Siegman; and James Wolfensohn, a former head of the World Bank who was more recently entrusted by the younger President Bush with reviving the Palestinian economy.

The letter's three key demands were that Mr Obama should appoint an even-handed special envoy with real clout (done); that he should spell out a clear vision for a Palestinian state (awaited); and that he should seek to draw Hamas into talks (not so easy). A key member of Mr Mitchell's staff, Fred Hof, who previously co-drafted Mr Mitchell's famous report on the state of the Israeli-Palestinian conflict in 2001, is close to the Scowcroft group.

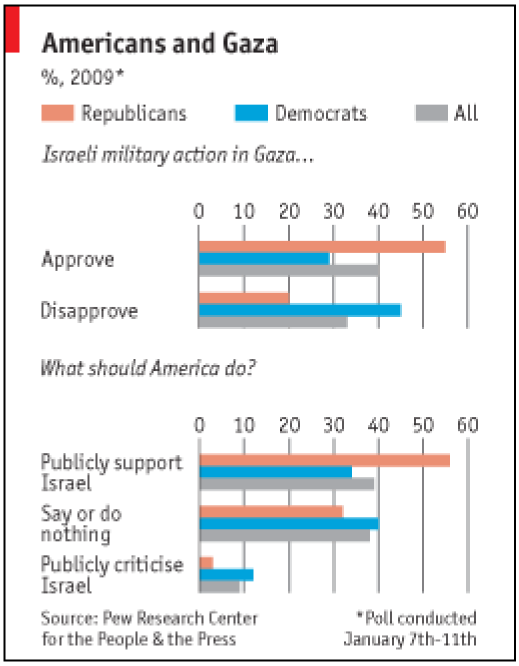
Mr Mitchell's appointment was warmly applauded by that group and greeted coolly by many in the old pro-Israeli lobbies, such as the American Israel Public Affairs Committee (AIPAC). More to the point, though there have been other recent envoys to the Middle East, none has as much potential influence on the president as Mr Mitchell. General Jim Jones, too, Mr Obama's new national security adviser, is a tough realist with recent experience in trying to improve security between Israel and Palestine. He is in hock to neither side.

No one is sure how Mrs Clinton, as secretary of state, will relate to Mr Mitchell—or to the Israelis and Palestinians. Since she became a senator for New York, she has ardently echoed more or less whatever AIPAC has said about Israel-Palestine. But some people recall how, when it was still controversial and her husband was president, Mrs Clinton called for a Palestinian state and even kissed Yasser Arafat's wife after she had castigated Israel, a moment of horror in AIPAC's eyes. Most probably, if Mrs Clinton sees a chance for a breakthrough to peace, she will go for it, whatever her previous constituents may think.

As for Mr Obama himself, no one is certain what he thinks; listening on such ticklish issues has been his forte. But those who have discussed Israel-Palestine with him reckon he is a lot more knowledgeable,

even-handed and open-minded than his predecessor. He will not jump into the morass without careful preparation, but there is a fair chance, once Mr Mitchell has drawn up a plan, that the new president will engage quite soon.

Most Americans still strongly back Israel in its determination to defend itself (see our table, left). Expressions of support for the Israelis during the Gaza war and an inclination to blame the Palestinians for starting it ran nearly four-to-one in the Israelis' favour. Evangelical Christians, a large and powerful constituency, still revere Israel as ordained by God to hold sway over the Holy Land.



But look harder at the polls and you see a striking shift in several sets of American attitudes, particularly among Democrats and liberal and younger Jews, which may give Mr Obama more room for manoeuvre. A big gap in support for Israel between Democrats and Republicans has opened up. Most striking is the emergence of a vigorous bunch called J Street, which declares itself "pro-Israel, pro-peace" but is far keener to see the Palestinian point of view. It is bluntly opposed to AIPAC and the array of groups that have backed Israel whatever the circumstances. In the new Obama era, the J Street people, together with a budding variety of other outfits, such as Americans for Peace Now, are on a roll, and are beginning to make at least some headway on Capitol Hill. Most strikingly, J Street has outspokenly called for Israel and its American friends to engage with Hamas.

AIPAC is still very powerful. Many congressmen who have lauded J Street for what it is doing are wary of backing it openly, though it says more than 40 (of 435 in the House of Representatives) have publicly accepted its endorsement. But AIPAC is rattled. The point that J Street makes most forcefully is that, in the end, AIPAC has been bad for Israel's security by invariably encouraging it to pursue policies that will not lead to peace with Palestinians.

Mr Obama has many friends who passionately back the Israeli cause, not least his chief of staff, Rahm Emanuel. The new man is also close to many young Jewish Democrats who sympathise with J Street's thesis that "tough love" is what Israel needs if it is to survive, by squeezing it into giving the Palestinians a fair deal. Many knowledgeable gloomsters think a two-state solution is too late already. Today's picture is bleak. But maybe there is a last-chance opening for a new president with a new team, new tactics, and a different set of pro-Israeli and pro-Palestinian backers, including Jewish ones, back home.

Israel's election

I won. No, I won

Feb 12th 2009 | JERUSALEM
From The Economist print edition

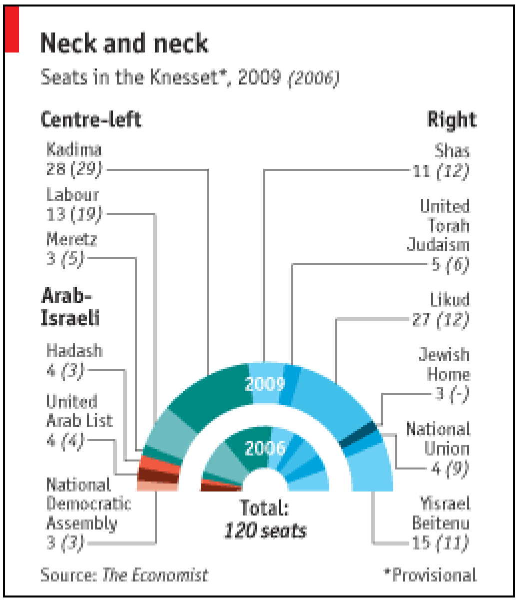
Much haggling, and some discretion, will be needed to form a new government

THOUGH his Likud party seemed to have lost the election on February 10th, by a whisker, to Tzipi Livni's Kadima, Binyamin Netanyahu has a good chance of becoming Israel's next prime minister. The rightist-religious block of parties, Mr Netanyahu's natural allies, emerged substantially stronger than the parties of the left which may back Ms Livni, the foreign minister, for the prime minister's office. Projections on February 11th, with the soldiers' vote still to be counted, showed Ms Livni's Kadima with 28 seats in the 120-seat Knesset and Mr Netanyahu's Likud with 27. The rightist-religious block numbered 65 to the left's 55.

But Mr Netanyahu is going to have to sweat. The blocks are fluid, their internal alliances fickle. Ms Livni, who came from behind to pip Mr Netanyahu at the post, is still fighting hard to keep him out of the prime minister's seat, despite the arithmetical handicap dealt by the results. On the night of February 10th, at televised victory parties, both candidates assured cheering supporters that they had won and would lead the new government. Neither is backing down.

On the first morning of what threatens to be a long and tortuous post-election haggle, Ms Livni met the ultra-rightist Avigdor Lieberman of Yisrael Beitenu—up from 11 seats to 15—and urged him to back her rather than Mr Netanyahu. "We can have a unity government", she said alluringly, "that advances causes important to you." She was alluding to Yisrael Beitenu's demand for civil marriage legislation (to loosen the grip of Orthodox rabbis on Israeli life) and electoral reform. Both of these are opposed by the Orthodox parties, Mr Netanyahu's allies. Ms Livni did not mention the less appealing—even racist—aspects of Yisrael Beitenu's platform.

"Our heart is with the right," Mr Lieberman told his cheering cohorts. "We want to see a nationalist government." But he pointedly stopped short of endorsing Mr Netanyahu, adding that his party's choice would be "not simple at all".



Kadima ministers point out that Mr Lieberman has sat in cabinets before, including one led by Kadima, and that his hustings rhetoric tends to subside in office. They note that he envisages an eventual two-state solution between Israel and Palestine, whereas in his platform Mr Netanyahu ruled that out, leaving little obvious room for serious peace negotiations. Mr Netanyahu, for his part, would prefer not to rule with the rightist-religious block alone. He wants a more moderate-looking coalition.

Labour, under the present defence minister, Ehud Barak, would be his preferred partner. But it crashed from 19 to 13 seats in the election. Mr Netanyahu could hardly offer Mr Barak the defence portfolio again on that poor showing. So, once he has consolidated his right-wing alliance, he will presumably turn to Kadima, and try, by persuasion and blandishments, to convince Ms Livni to set aside her own prime ministerial dreams and instead to join him in a broad-based government of the centre-right.

Reuters

No easy task for Bibi

He will cite the looming threat of Iran's nuclear ambitions, the more immediate challenges of Hamas and Lebanon's Hizbullah, and the economic depression, as reasons enough for Kadima to join him. And to sweeten the package, he may offer Kadima two big jobs: the foreign ministry for Ms Livni and the defence ministry for her deputy, Shaul Mofaz, who filled that post under Ariel Sharon.

The process of coalition-building will formally begin once the election results are officially published next week. President Shimon Peres must consult all 12 parties that have crossed the 2% threshold to get into the new Knesset, and then decide who should have the mandate to form a government. The candidate has up to six weeks to get the job done.

The presidency in Israel is a largely ceremonial position, circumscribed by law and convention. Choosing the prime ministerial candidate after a close-run election is the one circumstance in which the president can, sometimes, exercise a modicum of discretion. Mr Peres, who is 85 and has, in his long career, suffered his share of hung elections and unworkable governments, may well have some ideas of his own to get today's politicians out of their gridlock.

The politics of the recession

Gloom offensive

Feb 12th 2009 | WASHINGTON, DC
From The Economist print edition

The new president is storm-lashed, but still at the helm

Getty Images

FOR a man whose bumper stickers promised "Hope not Fear", Barack Obama knows how to scare people. "If we don't act immediately," he told the citizens of Elkhart, Indiana on February 9th, "our nation will sink into a crisis that, at some point, we may be unable to reverse."

No one doubts that America's economy is in a bad way. But the notion that it might never recover was previously entertained only by bearded survivalists stockpiling beans and ammunition in remote log cabins. Queried by a reporter about his "dire language", he could have admitted that he exaggerated a bit. Instead, he launched a waffly attack—three times longer than the Gettysburg address—on all those who doubted his warnings.

It worked. On February 10th, at Mr Obama's urging, the Senate passed an $838 billion stimulus package designed to jolt the economy out of its coma. That Senate bill then needed to be reconciled with an $819 billion bill that the House of Representatives passed on January 28th. The two measures are broadly similar, but include a different mix of spending and tax cuts. The Senate bill has more tax breaks, including temporary relief for the middle class from the alternative minimum tax and incentives to buy houses and cars. The House bill has more help for cash-starved states to build schools and provide health care.

House and Senate negotiators got straight to work haggling over a compromise. Harry Reid, the Senate majority leader, said on February 11th that a deal had been reached, in which the package was scaled back to $789 billion, partly by squeezing the tax break for homebuyers. But some details remained unclear. Since the House bill passed comfortably (without Republican support) but the Senate bill passed with only a vote to spare, Mr Obama still needed to keep the support of at least two of the three Republican senators who backed the bill—Olympia Snowe and Susan Collins of Maine and Arlen Specter of Pennsylvania—if the reconciled bill were to pass.

Also on February 10th, Tim Geithner, the treasury secretary, announced an outline of a plan to shore up the financial sector. Investors, who had been led to expect something clear and bold, panned it as vague and woolly (see article). The stockmarket plunged by almost 5%, tarnishing the new president's shine.

But Mr Obama remains far more popular than any party or political institution, and is campaigning hard for both packages. He hammers a few simple points relentlessly. America is in a terrible crisis. Only government can break the vicious cycle. If we don't hurry, things will get much worse. But if we act now, we can "save or create" up to 4m jobs.

A daily barrage of awful news supports his case. In January alone the economy shed 600,000 jobs, bringing the toll to 3.6m since the recession began in late 2007. Most Americans are either suffering or know someone who is.

Mr Obama uses wretched backdrops for his bully pulpit. On February 9th he visited Elkhart, a town racked by job losses since the local recreational-vehicle factories started cutting back. At a packed town-hall meeting, he was introduced by an unemployed father of seven. He bewailed the "families who've lost the home that was their corner of the American dream" and the "young people who put that college acceptance letter back in the envelope because they just can't afford it." The next day, he went to Fort Myers, Florida, a town where many people have lost their homes, and spoke to a family who live in a car.

A stimulus bill is both difficult and easy to sell. On the one hand, Americans like tax cuts and handouts as much as anyone. On the other, few understand the logic of borrowing your way out of financial difficulties. That is not how prudent households operate, they figure.

Republicans, who generally favour a smaller stimulus with more tax cuts, decry Mr Obama's bill as wasteful. For sound bites, they point to the $3m for golf carts, $1.65 billion for renovating government buildings and the requirement that many projects pay union wages. During more sustained fusillades, they denounce the "generational theft" of borrowing from one's children for a bill that may not work.

They cite an analysis of the first draft of the Senate bill by the non-partisan Congressional Budget Office. It predicts that it would boost the economy in the short term but make America slightly poorer than it would otherwise have been by 2019, because the immense debts incurred would have to be honoured. Democrats retort that the CBO describes its own predictions as "very uncertain". The predicted impoverishment is small (0.1% to 0.3% of GDP). And the stimulus might prevent a total calamity, they say.

Egregious "Buy American" provisions in the stimulus bill have been watered down. Mr Obama says he will make sure that the bill conforms to World Trade Organisation rules. But free-traders are far from content. The bill still encourages the government to indulge in whatever protectionist measures its lawyers may say it can get away with. That sets a terrible example for the rest of the world, says Gary Hufbauer of the Peterson Institute for International Economics, a think-tank.

Republicans also worry that the bill marks the start of a big expansion of government. Some recall that, when Franklin Roosevelt unleashed the New Deal to tackle the Depression, government grew beyond recognition and stayed big. They fear that Mr Obama plans to hire an army of bureaucrats, who will never be sacked and will mostly vote Democratic. And they fear a "tax tipping-point", when a majority of Americans pay little or no taxes and discover that they can vote themselves goodies paid for by others. Currently, the top 20% of earners pay 69% of federal taxes, and that share is rising.

Mr Obama has a holster of quick-fire retorts. To the Republicans' earnest discussions of history, he scoffs: "They're fighting battles that I thought were resolved a pretty long time ago." When they warn of the dangers of fiscal irresponsibility, he snorts that George Bush presided over a doubling in the national debt. Which is true, but dodges the point. His strongest weapon is to declare, falsely, that his opponents want to do nothing whereas he favours bold action. One thing is certain, though. When the economy recovers, which it surely will, he will get the credit.

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The National Security Council

Running the world

Feb 12th 2009 | WASHINGTON, DC
From The Economist print edition

The administration has far-reaching plans for the NSC

EPA

A man with a big plan

ONE of the favourite sayings in Washington, DC, is that "people are policy". But equally important is where those people sit in the organisational charts that define access to power. James Jones, the retired marine general who Barack Obama put in charge of the National Security Council (NSC), is drawing up an ambitious plan to reorganise his fief. Given that the NSC has broad responsibilities for shaping and co-ordinating national security policy—one insider portrait of the NSC is simply entitled "running the world"—this reorganisation could have big consequences.

Mr Jones is planning a significant expansion of the NSC's role. The NSC's purview can no longer be limited to the traditional stuff of defence and foreign policy, he argued this week in an article in the *Washington Post* and a speech at the Munich Security Conference; it must deal with a much wider set of threats, including terrorism, proliferation, cyber-security, overdependence on fossil fuels, disease, poverty, corruption and the economic crisis.

Mr Jones argues that the NSC can fulfil this expanded role by co-ordinating the work of an expansive list of government departments. This will mean that the NSC will be at the table when the administration shapes its policy towards issues that require broad co-operation across agencies, such as climate change and energy security. It will even mean that the NSC has a role in economic policymaking. All this may mean a significant expansion in the membership of the NSC.

Mr Jones wants to tidy things up as well as expand his council's power. He insists that he must be the primary channel of national-security advice to the president. (One of the reasons why policymaking was such a mess in 2000-04 is that Dick Cheney and Donald Rumsfeld constantly went behind Condoleezza Rice's back.) He wants to encourage the departments of Defence and State to harmonise their organisational maps (the former treats Israel as part of Europe whereas the latter calls it part of the Near East). He also wants to take over some of the responsibilities of the White House homeland-security council.

How this will go down with other parts of the administration, particularly the State Department, is unclear. Mr Obama's foreign-policy apparatus is already overcrowded with big personalities, such as Hillary Clinton, Richard Holbrooke and George Mitchell, who may not take kindly to their assigned roles in Mr Jones's organisational chart.

South Carolina

You can keep your money

Feb 12th 2009 | COLUMBIA
From The Economist print edition

A backlash against stimulus plans

MARK SANFORD, South Carolina's penny-pinching governor, has been called a rising star by Michael Steele, the new chairman of the Republican National Committee. But the star may well be about to crash to earth, in his home state at least. The recession has hit his state particularly hard; but he has been staunchly opposed to the federal government's stimulus package, which would bring South Carolina an estimated $2 billion-3 billion.

So will he take the money, now that the stimulus plan looks likely to be enacted? "We'll cross that bridge when and if we get to it," is all Mr Sanford's spokesman has said. This has so upset the state's top Democrat in Congress, House majority whip Jim Clyburn, that he has proposed a bill that would get the funds to the state even if Mr Sanford is against them. The handful of other Republican governors who oppose the stimulus package in principle—including Sarah Palin of Alaska, Tim Pawlenty of Minnesota, Bobby Jindal of Louisiana and Don Carcieri of Rhode Island—concede they will take the money if it becomes available.

South Carolina's economy desperately needs a jolt. Its unemployment rate of 9.5% is the highest it has been for more than 25 years, and the third-highest in the country. The downturn means that some $1 billion has gone from the state's budget of $7 billion since July, cutting deeply into funding for education, prisons, health programmes for the old, the disabled, and children, meal deliveries for the housebound, and everything in between.

Mr Sanford, recently elected head of the Republican Governors Association, has been leading the charge against the stimulus because it will increase debt, and because government spending is something he famously feels strongly about.

When he was a congressman, from 1995 to 2001, he slept in his office on Capitol Hill rather than use a taxpayer-funded allowance for housing. In 1997 he voted against a defence appropriations bill that included funds for Charleston's historic harbour, which is located in the district he then represented. In 2004, as governor, he let two piglets loose in the South Carolina state house as a protest against pork.

Mr Sanford has vetoed hundreds of bills approved by the Republican-controlled legislature during his six years as governor, mostly over what he considered wasteful spending. These include such outrages as expanding children's health insurance, funding HIV-prevention programmes and increasing the fine for neglecting to put a child in a car's safety seat. The legislature, both chambers of which are controlled by Republicans, has overturned nearly all of the governor's vetoes.

Now he is feuding with his state's Employment Security Commission, the agency that doles out cheques to the state's 200,000 jobless. Mr Sanford, who says the commission is mismanaged (it is broke), plans to sack its commissioners unless they provide him with better data on who is collecting unemployment benefits. The agency director says their data are fine; the jobless claims have simply ballooned over the past few months.

The NAACP at 100

Much still to do

Feb 12th 2009 | NEW YORK
From The Economist print edition

But America's oldest civil-rights outfit is redefining its role

AP

Zealous Jealous

DURING the summer of 1908, riots raged through Abraham Lincoln's hometown of Springfield, Illinois. The quiet removal of two black men who had been held in prison as suspects in two separate attacks on white people enraged the white community. They took out their anger on black residents and black-owned businesses and properties. The riots went on for two days and simmered for longer; seven people were killed and some $200,000 worth of damage was done.

The following February, partly in response to the Springfield riots, a group of Jewish, white and black activists met in New York to found the National Association for the Advancement of Coloured People (NAACP) whose aim was, and remains, to ensure "the political, educational, social, and economic equality of rights of all persons and to eliminate racial hatred and racial discrimination".

The NAACP celebrated its centenary on February 12th. It has played a leading role in bringing down racial barriers, notably in overturning Jim Crow laws and in its work on the 1954 case of *Brown v Board of Education,* which brought about the desegregation of America's schools. But the changes in America since then have also brought challenges. America now has its first black president; evidence, to some, that the NAACP's work is done.

Benjamin Jealous, who recently took over as the NAACP's youngest ever president, at 36, disagrees. "There are still a lot of things to be angry about," he declares. "Young black people in the US are the most incarcerated people in the world. They understand, by virtue of their situation and that of their peers, that the movement for civil rights in this country is very much needed and groups that played critical roles in removing the shackles that bound our forefathers and foremothers still play a role today." The statistics back him up. The unemployment rate for black Americans is 12.6% compared with 6.9% for white Americans; their life expectancy five years less; and black infant mortality rates are twice the national average.

Mr Jealous's youth may help him with another challenge. In the 1960s the NAACP boasted around half a million members. Membership has since dropped to less than 300,000, out of a population of some 41m African-Americans. Many people think that a generational divide, which has seen those who have grown up in a more integrated America become increasingly estranged from the organisations and leaders who fought for their rights, is to blame.

In a segregated America, the NAACP's role in helping the black community was undeniable. But that has

changed: a recent Gallup poll revealed that nearly 70% of Americans, the highest number it has ever recorded on this issue, believe that relations between black and white Americans “will eventually be worked out”. And these days it is Hispanics, who also face big inequalities, that make up the largest minority, not blacks. The NAACP’s approach is shifting accordingly; the black minority needs allies. Mr Jealous, in fact, reckons his task is now about “organising a plurality”. If the NAACP is going to regain its former pre-eminence “the way that we talk about issues, the way that we build coalitions and the nature of the struggle at this moment” must be “in universal terms”. That Mr Jealous is the son of a white father and a black mother may help him.

The work of the organisation, though, has not changed so very much. Mr Jealous says his main concerns are still the quality of schools, the jobs market and the quality of the justice system. But activism, too, must now be colour-blind.

Philadelphia

A Nutter crisis

Feb 12th 2009 | PHILADELPHIA
From The Economist print edition

Unhappiness is growing at the scale of cuts needed

PHILADELPHIANS love their libraries. Benjamin Franklin opened the first successful lending library in America there in 1731. The first free library was chartered in 1891. Andrew Carnegie donated $1.5m for the construction of two dozen more in 1903. Even as the city's population fell, new libraries kept opening. So it was a big deal when Michael Nutter, the city's mayor, decided in November to close 11 of them in an effort to cope with the city's fiscal woes.

Philadelphia's problems are huge and getting huger. By law the city's five-year fiscal plan must be balanced annually. As well as seeking emergency federal help for public pensions, infrastructure, and access to capital for short-term cashflow, Mr Nutter has been forced to make difficult cuts. Every department's budget has been slashed and will probably still lose another 10%-30%. His rescue plan so far has delayed tax breaks and reduced the city's payroll. He has cut his own salary by 10%. Seven fire companies and several city swimming pools are on the chopping block. Mr Nutter has been forced to hold a series of town hall meetings to explain the cuts and the crisis. He got an earful, especially over the libraries.

It has all been a far cry from this time last year. Mr Nutter's inauguration in January 2008 saw Philadelphians waiting for up to four hours outside City Hall to shake his hand. Not unlike Barack Obama, he was elected with a mandate for change, promising a "new day and a new way". He pledged to reduce murders, add new police officers, make the city greener and bring more jobs to Philadelphia.

Expectations were high. And given the budget constraints, Mayor Nutter did well in his first year. He hired 200 more police officers, though that was fewer than the 400 promised. Murders were down 15% in 2008, the sharpest decline in a decade; not the ambitious 25% hoped for, but still a worthy drop in a city once nicknamed "Killadelphia". One district saw a 72% decrease in murders. On February 6th Mr Nutter launched the "Splash and Summer FUNd" campaign, a public-private fund-raising partnership to keep open 20 swimming pools that had been scheduled to close. But the dire fiscal state of the city has overshadowed these successes.

In January a judge issued a ruling claiming Mr Nutter needed city council approval or a court order to implement his library plan. The mayor is fighting the decision, which he says reinterprets the city's charter and undermines mayoral power. The libraries remain open, for now. But City Hall claims it can't afford to do that for long. "I don't like these cuts either," said Mr Nutter at one town-hall meeting; but the economic situation is forcing his hand. There was some encouraging talk of leasing the libraries for community use, but the court order prevents this. Even with the closures, Philadelphia will still have more libraries per head than any other big city. Closing the 11 branches would save the city $8m a year.

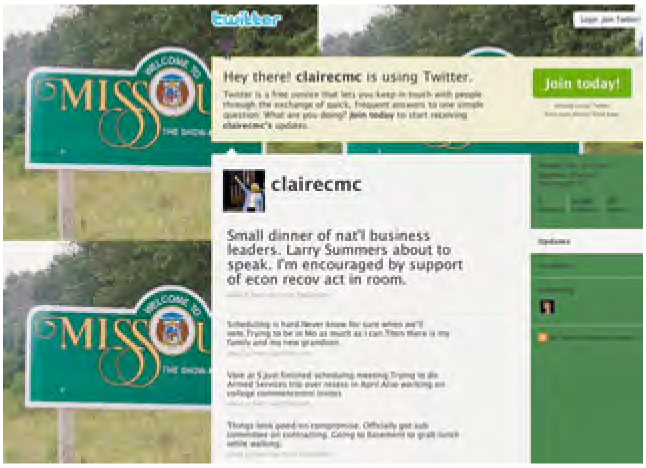
Renegotiating municipal union contracts would also save badly-needed dollars. Mr Nutter wants to reduce health-care costs; only Detroit pays more. Annual pension cost rises are outpacing the growth of the city's pension-fund revenues. The mayor wants to eliminate birthdays as paid holidays for police officers. Mr Nutter is still viewed favourably by most city residents, according to a recent survey, but they are overwhelmingly unhappy about the cutbacks. By helping organise a series of public workshops and consultations on the budget, he hopes for more input (and a bit more sympathy) from voters.

Politicians on Twitter

Tweeting the people

Feb 12th 2009 | AUSTIN
From The Economist print edition

An internet craze reaches Congress



ON A recent evening John Culberson, a Republican congressman from Texas, used the micro-blogging service Twitter to field a dozen comments from around the country. He told a panicked man in Wisconsin not to be too frightened about the economic crisis: America would pull through. He told another follower that he wanted public hearings on the stimulus package, but that Nancy Pelosi was standing in the way. A man from Arizona wanted to know: PC or Mac? PC, said Mr Culberson; he missed his Mac, but the federal government plumps for Windows.

When politicians say they want to talk to their constituents, it is often a polite fiction. But dozens of men and women in Congress have discovered that they can use Twitter to keep in touch. Pete Hoekstra, a Republican representative from Michigan, recently caused Congress's first "twitterversy" when he tweeted that he was in Baghdad, which struck some critics as a security risk.

Most politicians tweet to promote themselves. They (or their staffers) use the service to distribute press releases and friendly editorials. But others have embraced the informal nature of the medium. Claire McCaskill, a Democratic senator from Missouri, offers a good mix of thoughts on policy, political titbits, and personal asides. "Compromise had to happen or we would NOT have 60 votes. Period," she tweeted during negotiations over the stimulus bill. Earlier she described some hungry politicians: "Hysterical. Swarming Senators around candy drawer in back of Chamber."

Mrs McCaskill comes across like a friendly and candid citizen legislator. But whereas more than 4,000 people "follow" her, she follows only one person herself. In that respect she lags behind people like Mr Culberson, who use their Twitter accounts to talk to people.

More Republicans are twittering than Democrats. Wynn Netherland, who co-founded the tracking site TweetCongress.com, theorises that this is because Republicans are in the minority. Perhaps their frustration has spurred them to take their case to the public. As long as they are not just squawking into the void.

Environmental politics

Tree-huggers v nerds

Feb 12th 2009 | LOS ANGELES
From The Economist print edition

As the planet heats up, so do disputes between environmentalists

LAST December California approved a power line between San Diego and the Imperial Valley—a spot blessed with sun, wind and geothermal energy resources. The Sunrise Powerlink would twist around a state park, an Indian reservation and much of a forest (see map). Its builders would be banned from harming burrowing owls or rattlesnakes. It is just the sort of green infrastructure project that might be expected to delight environmentalists. Their response? An appeal and a petition to the state Supreme Court.

“Environmentalists have never been a well-mannered lot”, says Terry Tamminen, who has advised Arnold Schwarzenegger on climate change. But they seem to be becoming more ornery. A growing fear that the environment is on the brink of collapse is making many greens less willing to compromise, even with each other. And George Bush’s departure from the White House has removed a common adversary.

The fiercest disputes are over electricity transmission. Many environmentalists, including Mr Schwarzenegger, argue that more power lines must be built to connect cities with potential sources of renewable energy. The governor strongly supports the Sunrise Powerlink project. The Sierra Club opposes it, along with another line that would run east from Los Angeles. Together with the Centre for Biological Diversity, the organisation is holding out for a guarantee that the line will be used to transmit electricity solely from renewable sources. Environmental groups in Nevada and the Midwest have issued similar ultimatums.

To an extent this is a dispute between pragmatism and idealism. Politicians like Mr Schwarzenegger tend to believe that energy projects should be judged on whether they improve on current practice. Activists, by contrast, prefer to measure them against an environmental ideal. “A little bit better than the status quo isn’t good enough,” explains Bill Magavern, the Sierra Club’s California director. He wants power to be generated close to those who will use it, and envisages a rash of solar roofs in San Diego.

A more profound difference has to do with how the problem is diagnosed. Although no big environmental group is unconcerned with global warming, they view the threat in different ways. The big divide is between those who fret about measurable changes in greenhouse-gas emissions and those who worry more about harm to natural habitats, whether caused by global warming or anything else. The first group—call them the environmental nerds—includes people like Al Gore and Mr Schwarzenegger. The second group—call them the tree-huggers—includes the Sierra Club, the Centre for Biological Diversity and other established conservation groups.

The dispute is likely to intensify in the next few months as Washington weighs in. This week Congress reached a deal on a stimulus plan that encourages the construction of yet more power lines. Barack Obama wants to create green jobs, but he needs to create jobs above all, and quickly. Environmentalists, who know how to hold up big projects better than anybody, will not be bounced so easily. A shame: after all, the greens are winning.

Sex education

Just say no

Feb 12th 2009 | NEW YORK
From The Economist print edition

Abstinence-only education is up for grabs under the new government

JUDITH VOGTLI, director of an upstate New York-based abstinence organisation called ProjecTruth, is worried that the golden age of "abstinence-only" education may have come to an end. George Bush junior helped increase funding for this kind of sex education—which focuses on chastity as the way to prevent pregnancy and sexually transmitted diseases, and discusses condoms only in terms of failure—to over $175m a year. The fate of that money, and of abstinence education itself, is uncertain under a new administration and Congress.

Ms Vogtli need only wait a few weeks. Barack Obama will submit the first draft of his budget to Congress later this month. In the meantime, her organisation, funded entirely by a government grant, is trying to go about business as usual. That means teaching about abstaining from sex, drugs and alcohol in New York schools and holding its sixth annual abstinence Creativity Contest, to which students submitted essays, poems, artwork and music on the theme of "Waiting is easier because…"

Abstinence-only education programmes have been controversial ever since they were introduced under Ronald Reagan in 1981. Some liberals have labelled it "ignorance-only" education and most favour a curriculum that includes discussion of both abstinence and contraception. Since the start of abstinence-only programs, the federal government has spent over $1.5 billion on them, but the United States still has one of the highest teen-pregnancy rates of any developed country.

Supporters of abstinence-only education mostly think that the media and a culture of promiscuity are to blame for this and that more government support for abstinence could help offset the rise of teenage pregnancy and sexually transmitted disease. But opponents blame abstinence-only education.

There is some evidence to support their case. According to Sarah Brown of the National Campaign to Prevent Teen and Unplanned Pregnancy, an advocacy organisation, there has been no randomised study showing that abstinence-only education delays sexual activity, and research from the University of Washington suggests that teens who receive comprehensive sex education have a 50% lower risk of becoming pregnant than those enrolled in abstinence-only courses.

Abstinence-only advocates want the government to let school districts choose which type of sex education they prefer. But in an ominous sign for them, the new Congress is already shifting its emphasis. Louise Slaughter, a congresswoman from New York and a former scientist, has introduced a bill that would fund "medically accurate" comprehensive sex education in schools. It is likely to pass.

Lexington

The war over Lincoln

Feb 12th 2009
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America is throwing a big birthday party for its 16th president, and everyone wants a share

Illustration by KAL

ILLINOIS has been calling itself "the land of Lincoln" for decades. This week the entire country is laying claim to the title. Every place with a significant connection to the great man, from Louisville, Kentucky, the largest city in the state where he was born, to Springfield, Illinois, where he made his career in law and politics, to Gettysburg, on whose battlefield he delivered his immortal address, is marking the 200th anniversary of his birth. In Washington, DC, Congress is holding a bicameral tribute; the refurbished Ford's Theatre, where he was assassinated, is reopening with a new play about Lincoln's life; and the Library of Congress is unveiling an exhibition of Lincoln memorabilia.

Lincoln is one of the world's most written-about men, along with Napoleon and Jesus, with 16,000 books on him written since his death in 1865 and a new Lincoln book coming out, on average, every week. But in this bicentennial year a flood is turning into a torrent. More than 60 Lincoln-themed books are being published to mark the bicentennial month, and Michael Burlingame's 1m-word biography is about to go online.

Such Lincolnmania is hardly surprising. For all its claims to youth and energy, America is a history-obsessed country, with books on the founding and the civil war earning a permanent place, along with self-help books, on the bestseller lists. Lincoln is arguably America's greatest president (Washington, the other obvious claimant to the title, is regarded more as a god than a man). Lincoln's 200th birthday is also following hard on the heels of the inauguration of America's first black president, a man who is married to a woman whose ancestors were traded like cattle in Lincoln's time.

But a cause of national celebration is also, inevitably, an excuse for partisan manoeuvring. Barack Obama has made a concerted attempt to present himself as a latter-day Lincoln, keeping a portrait of the martyred president on his desk and taking his oath of office on Lincoln's Bible. He referred to Lincoln in the speech in Springfield that launched his election campaign, in the victory speech in Chicago that ended it, and in his inaugural address, which he devoted to the subject of "a new birth of freedom". The new president travelled to Springfield this week to celebrate Lincoln's birthday.

Some of this is nothing more than innocent, if irritating, grandiosity. The comparisons between the two Illinois politicians are, after all, striking. "In Lincoln's rise from poverty", Mr Obama wrote in *Time* in

2005, “his ultimate mastery of language and law, his capacity to overcome personal loss and remain determined in the face of repeated defeat—in all this, he reminded me…of my own struggles,” prompting Peggy Noonan, a conservative commentator, to quip that Mr Obama is “like Abraham Lincoln, only sort of better.” But there is also a good deal of calculation.

Much of it reflects the Democrats’ conviction that they, rather than the Republicans, are the real “party of Lincoln”. The Republicans’ most solid base these days is in the states that once formed the Confederacy that fought to preserve slavery; the Democrats now control almost all the Union states, including Illinois. The Democrats also regard themselves as the champions of other marginalised groups, from Latinos to homosexuals.

The Republicans are belatedly pushing back. Earlier this month, during the opening rounds of the election for their new party chairman, all the candidates, without exception, named Ronald Reagan as their favourite president. But when it became clear that the party was about to elect its first black boss, Michael Steele, it rediscovered its inner Abe. Kenneth Blackwell, another black candidate, endorsed Mr Steele by urging the party to make good “on the promise of Lincoln”. Mr Steele described his victory as “one more bold step that the party of Lincoln has taken”.

So who can really claim Lincoln’s mantle? In some ways, both sides can. Both parties embrace Lincoln’s vision of America as a model of democratic government to the world, and both want to be more inclusive. The Republicans do appear to understand that they cannot survive as the party of white southern voters. Mr Bush appointed more members of minorities to his administration than any previous president, including two black secretaries of state in a row. Mr Steele’s election is a sign of the party’s continuing commitment to expanding its base.

The forgotten meritocrat

But, in other ways, both sides have shortchanged one of Lincoln’s most important ideals: that of self-help and upward mobility. Lincoln was not just content to be a personal example of upward mobility—born, in the poet James Russell Lowell’s phrase, “out of the very earth, unancestried, unprivileged, unknown”. He believed that the essence of the promise of American life was “to lift artificial weights from all shoulders” and “afford all an unfettered start, and a fair chance, in the race of life.”

Both parties continue to pay lip service to this ideal. But they have done far too little about America’s rusting ladders of opportunity. Mr Bush’s Republicans cut the top rates of tax at a time when the richest Americans were amassing unheard-of wealth, and widened the gap between rich and poor while turning a healthy budget surplus into a big deficit. The Democrats are wedded to a system of affirmative action that judges people on the basis of their race rather than their individual merits. They are also in the pockets of teachers’ unions which have fought relentlessly against introducing more competition or standardised testing into the public schools. Mr Obama, like Bill Clinton before him, has sent his own children to a private school, Sidwell Friends, while simultaneously anathematising voucher schemes that would allow those less wealthy to do the same. If the hottest political question in this bicentennial week is “what would Lincoln do?”, then the first answer is surely try a lot harder to repair America’s faltering commitment to meritocracy.

Rebuilding Haiti

Weighed down by disasters

Feb 12th 2009 | GONAÏVES
From The Economist print edition

A modest success for the United Nations is threatened by nature and lassitude

AFP

THERE is a new lake outside Gonaïves, a town of 300,000 people and the fourth-largest in Haiti. It blocks the road south to the capital, Port-au-Prince. It formed last autumn when four storms, three of them hurricanes, swept over the poorest country in the Americas in the space of a month. The rain—a metre's worth on one night alone—fell on saturated mountains, long since denuded of their forest cover, and swept down on to the coastal plain. It seemed a modest victory that only 793 people died, compared with 3,000 killed by Hurricane Jeanne in 2004.

Five months later, bulldozers have cleared the mud from the main streets of Gonaïves. Away from them, on countless side streets, pedestrians look down on rooftops on either side. The houses have been dug out by hand, and the dirt piled in mounds on the roadway.

Only 20% of the town has been cleaned up, estimates Olivier Le Guillou of Action Contre la Faim, a French charity, which has paid 1,800 residents to help do the job. The damage was not confined to Gonaïves. Haiti's agriculture minister reckons that 60% of the harvest was lost and 160,000 goats were killed, along with 60,000 pigs and 25,000 cows. In all, the storms have cost the country $900m, or 14.6% of GDP, according to a donor-funded government study. That is equivalent to 12 times the damage of Hurricane Katrina in the United States, and comes just four years after Jeanne wiped out 7% of Haiti's GDP.

Nature is not the only force knocking Haiti back. Since Jean-Bertrand Aristide, a left-wing former Catholic priest, was overthrown by a rebellion in 2004, the country has been in the care of the United Nations. Some 7,000 UN soldiers and 2,000 police, mainly from Latin America, keep the peace. The UN mission has brought greater security: reported kidnappings fell from 722 in 2006 to 258 last year. A new UN-trained Haitian police force now has 9,000 officers. The streets of Port-au-Prince are visibly cleaner.

But this has not stimulated economic progress. Three-quarters of Haitians still live on less than $2 a day. Two in five children don't go to school. A quarter of districts lack schools; where these exist, there are 78 pupils per teacher. In 2005, the maternal death rate rose to 630 for every 100,000 births, up from 457 in 1990. Though more than half of Haitians work in farming, they produce less than half the country's food needs. Haiti's agriculture is the least productive in the world, says Joel Boutroue of the United Nations

Development Programme (UNDP). A hectare of rice paddy in Vietnam will produce 20 tonnes of rice a year, whereas a Haitian hectare yields just one tonne.

Trends in the outside world have added to Haiti's home-grown woes. Last April the rise in food prices brought riots that toppled Jacques-Edouard Alexis, the prime minister. In January it was almost impossible to find a litre of petrol (though diesel was available). Rumour holds that Venezuela halted delivery of subsidised oil under Petrocaribe, a scheme which saved Haiti's government alone at least $200m last year. Any boost that might have come from a law approved last year which grants Haiti's textiles duty-free access to the United States has been more than nullified by the slowdown in remittances (down 20%) and exports because of the American recession. According to the Economist Intelligence Unit, our sister organisation, the economy will contract by 0.5% this year.

But some of the problems are the fault of Haiti's politicians. René Preval, who was elected president in 2006 to widespread acclaim among Haitians and outsiders alike, now seems indecisive. It took him five months to form a new government after Mr Alexis went, and then many aid projects had to be renegotiated from scratch. Mr Preval has warned Haitians of a difficult year ahead.

"People want to see more than pessimism from a leader, they want to see proposals," says Kesner Pharel, an economist and political analyst. The president is not the only one to blame. Hedi Annabi, the UN's official in Haiti, recently criticised the country's politicians for wasting time in "infinite debates" instead of "working for the essential needs of destitute Haitians".

Corruption is deeply rooted. The family and friends of politicians and civil servants expect "to benefit from privilege", says Gary Victor, a novelist. Money that was supposed to build better drains in Gonaïves after Hurricane Jeanne was siphoned off, says a UN official. There are plans to terrace the hills above the town, to plant shrubs and dig canals. But political lassitude means that this will not get done before the next hurricane season. The prisons remain an overcrowded horror, with four-fifths of the inmates yet to face trial.

The only business that seems to thrive is drug trafficking. The police chief in Port-de-Paix, in the north-west, was poisoned in January after several million dollars of cash seized from the uncle of a prominent drug-smuggler went missing. Guy Philippe, a former soldier who led the rebellion against Mr Aristide and whom the Americans accuse of drug-trafficking, says he will run for the Senate.

Next month aid donors will convene for a conference on Haiti, the first since the autumn of 2006. In response to the hurricanes they have doubled aid to $800m a year (half of this comes from the United States). That is on top of the UN mission's $600m annual budget, and Venezuela's fuel subsidy. Some things have been achieved in Haiti since 2004, but more should have been. "We spend a lot of money doing capacity building, but it is not clear that this has an impact," says Mr Boutroue of UNDP. "Maybe we are just buying social peace—instability has just as much to do with the well-being of members of parliament as with a deepening of poverty." It is surely time for outsiders to hold Mr Preval and the politicians to account.

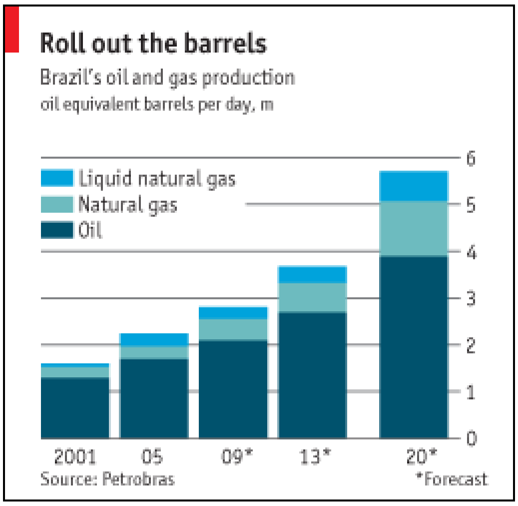
Brazil's oil industry

Plunging in

Feb 12th 2009 | SÃO PAULO
From The Economist print edition

Petrobras sets some ambitious targets

AMID all the graphs resembling ski slopes which plot jobs and car sales, the boldness of Petrobras may come as a relief to Brazilians. Last month the state-controlled oil giant published its revised investment plan for the next five years. Its proposed capital spending of $174 billion over this period is bigger than the entire economy of Chile. By 2020, if all goes to plan, Petrobras and its foreign partners will be producing 5.7m barrels of oil and gas per day (see chart), more than half the output of Saudi Arabia. New refineries and gas terminals are planned, as well as drilling rigs (29 of them to be delivered by 2012, with a further 28 arriving by 2017). And all this after the oil price has fallen by $100 a barrel from its peak last year.



When Petrobras announced in November 2007 that it had made the biggest oil discoveries of this century deep below the seabed, politicians became intoxicated at the prospect of untold riches. The government withdrew exploration rights in nearby areas from auction, and talked of setting up a new wholly state-owned company to do the job. It proposed a sovereign-wealth fund in which to house the treasure. Only a few critical voices worried that oil wealth might aggravate some of Brazil's problems, such as corruption, resistance to reform and public-sector inefficiency.

The fall in the oil price, and the realisation that not much will be pumped from the new field until 2013, have cooled the fever. The Petrobras plan assumes that the current licensing regime remains in place. The company proposes to spend around $6 billion a year developing the new fields, which lie between five and seven kilometres under the sea, beneath a thick layer of unstable salt. The technical challenges are huge. Just getting workers to the rigs will be tough: some of them will sit 300km (185 miles) off the coast, requiring helicopters to carry three times their normal fuel.

José Sérgio Gabrielli, Petrobras's chief executive, is undaunted. “We have the technology and access to reserves and we think we can finance it. Why not?” He says the biggest problem is to gather data about the nature of the field in order to minimise drilling. Others wonder whether in a world where credit is crunched, Petrobras can raise the cash.

Mr Gabrielli reckons Petrobras can generate $10 billion from operations this year and $12 billion-16 billion next year. These assumptions are conservative, says Gustavo Gattass of UBS Pactual, an investment bank. Petrobras has secured a large slug of cheap funding from BNDES, Brazil's state development bank. It is negotiating a $5 billion bridge loan from a syndicate of five banks, which would give it up to two years to pick its moment to raise a similar amount in the bond market. This month it issued $1.5 billion of debt at an interest rate of 8 1/8%—a vote of confidence from wobbly financial markets. The company is also talking to the export-credit agencies of countries that supply it with equipment (such as the United States) or that might import its oil (such as China).

Even so, some Brazilians suspect the investment plan has been inflated to please the politicians who sit on Petrobras's board. This is chaired by Dilma Rousseff, whom Brazil's president, Luiz Inácio Lula da Silva, has anointed as his favoured candidate in the presidential election due next year. Proposed spending on new refineries may fail to materialise, argues Edmilson dos Santos of the University of São Paulo's Institute of Electronics and Energy. “Lula has made a lot of the idea that Brazil must refine its own oil but the market is in crude, as are the profits,” he says. He also predicts that Petrobras will end up flaring much of the gas that rushes out with the oil, rather than spending lots of money to liquefy it to generate electricity.

Mr Gabrielli insists that the investment in the sub-sea field can pay its way even if the oil price averages no more than its current level of around $45. With many oil companies cutting investment and production, the price may well be higher than that by the time the oil comes up from below the ocean. That, at least, is the reasonable bet behind an ambitious plan.

Canada and NAFTA

No mariachis, please

Feb 12th 2009 | OTTAWA
From The Economist print edition

Some Canadians think they are more important than Mexicans

FOR the past 15 years Canada and Mexico have been joined with the United States in the three-way North American Free-Trade Agreement. But both still set much more store by their bilateral relationship with their superpower neighbour. This has led to sometimes farcical rivalry. To the joy of Canadian officials, Barack Obama is making his first, albeit brief, foreign visit as American president to Ottawa on February 19th. But Mexican officials whisper that their president, Felipe Calderón, got in first with a lunch with Mr Obama days before his inauguration.

More seriously, a growing number of Canadians, including politicians, trade negotiators and former ambassadors, have called for their government to turn its back on NAFTA and put all its efforts into improving bilateral ties with Washington. Canada was always a reluctant member of NAFTA, joining the talks mostly to safeguard gains made in a bilateral free-trade deal with the United States concluded five years earlier. Politicians chafe when Canada is lumped together with Mexico, as happened last year during Mr Obama's campaign when he vowed to renegotiate NAFTA to protect Americans from weak environmental and labour standards. Even more woundingly, Janet Napolitano, the new secretary of homeland security, who is a former governor of Arizona, ordered a review of the northern border, saying that it presented a greater terrorist threat than the southern one.

Peter Harder, a former Canadian deputy foreign minister, argues that NAFTA holds back bilateral ties. "It is not in our interests to allow the speed of three to define the relationship of two," says Mr Harder. "We have trilateralised for too long." That view has been echoed by John Manley, a former Liberal deputy prime minister.

In fact many cross-border problems differ only in degree. That applies to the drug trade, gun smuggling, border security, the environment and illegal immigration. All three countries have a stake in the floundering car industry, which is organised on a North American basis. Canada and Mexico are the United States' top two suppliers of imported energy, giving them both an interest in Mr Obama's plans for energy and environmental measures.

Few Canadians speak up for enhancing ties with Mexico. But before leaving Ottawa this month, Emilio Goicoechea, Mexico's ambassador, wrote a rebuttal urging Canada to stay the trilateral course. Trade between the two has grown fivefold since 1994 to $21 billion in 2007—though that is dwarfed by the United States' two-way trade with Mexico, worth $349 billion, and with Canada ($566 billion). Some Canadian companies have invested in Mexico: Bombardier has factories making aircraft parts and trains, while Scotiabank is Mexico's seventh-biggest bank.

In questioning NAFTA, Canadians do not just risk playing to protectionists in America's Democratic Party. Their belief that on its own Canada would get more attention than Mexico also looks misplaced. Canada's economy may be 40% bigger, but its population is much smaller. Mr Obama has recognised that he owes his electoral victory in part to Hispanic voters (most of whom are of Mexican descent). More than half a million Americans live in Mexico. And the security problems in Mexico caused by the American demand for cocaine are a growing worry to policymakers in both countries.

"By working together with Mexico we remain on the radar screen," says Carlo Dade of the Canadian Foundation for the Americas, a think-tank. Canada's prime minister, Stephen Harper, has made no comment on trilateral relations, except to oppose reopening NAFTA. He has made Latin America a foreign-policy priority, and gets on well with Mr Calderón. When the Buy America provisions of the American Congress's economic stimulus plan hit the news, Mr Harper called Mr Calderón to confer on how to fight protectionism. The Democrats in Congress may have unwittingly handed Canada and Mexico something big their relationship has lacked in the past—a common cause.

Antarctic tourism

Waiting for another Titanic

Feb 12th 2009 | SANTIAGO
From The Economist print edition

The risks of a holiday with icebergs

IT IS not quite Benidorm yet, but Antarctica has become an increasingly popular destination for the more adventurous tourist. In this year's southern-hemisphere summer season, running from November to March, as many as 39,000 visitors are expected to make the trip from Tierra del Fuego, the nearest jumping-off point to the world's emptiest continent. That amounts to a fourfold increase in a decade. Officials in both Chile and Argentina are getting increasingly worried about the risk of a fatal accident—"a new *Titanic*" as one Chilean naval officer puts it.

Nobody has died so far, but there have been some near-collisions. In 2007 more than 150 people were evacuated when their ship, the *Explorer*, sank after hitting an iceberg near the South Shetland Islands. They were "very lucky with the weather", says Chile's deputy minister for the navy, Carolina Echeverría. That was one of only two accidents last season, with a similar number the previous year and one so far this season.

Help is usually not far away. Although cruise ships plan their itinerary so as to keep out of each other's sight, there are generally 20 to 30 boats heading to or from the Antarctic peninsula on any one day, according to Steve Wellmeier of the International Association of Antarctica Tour Operators.

Even so, surviving an accident is something of a lottery. It depends partly on the weather. Not all the ships have the covered lifeboats recommended for polar conditions. Small boats, like the *Explorer*, have a better chance of being able to transfer their passengers if they get into difficulties. But some cruise ships visiting Antarctica now carry almost 3,000 passengers—more than ten times the limit that offers a reasonable chance of timely rescue, according to Chile's navy.

The navy is chafing at the cost of patrols, rescue operations and cleaning up fuel spills. It wants legally binding rules, backed by penalties, for Antarctic cruise ships. But that is hard to achieve. Under the 1959 Antarctic Treaty no country can exercise sovereignty over any part of the continent and its waters are international. Some rules on tourism have been written under the treaty: cruise ships carrying over 500 passengers cannot make landings, for example. But these are not legally enforceable. Neither will be rules being debated by the United Nations' International Maritime Organisation on safety requirements.

Some tour operators say they would welcome tighter regulation and higher safety standards. Others insist that safety is already adequate. The world recession may place a temporary brake on the trade. But Chilean officials reckon that the trend to big cruise ships, with their cheaper fares, will resume once recovery comes. If so, a tragedy may be only a matter of time.

Economist.com WORLD ASIA

Australia's wildfires

The burning bush

Feb 12th 2009 | SYDNEY
From The Economist print edition

EPA

The worst wildfires on record give Australia a week in hell

A WEEK after bushfires started blazing across parts of southern Australia, the country was still coming to grips with one of the most traumatic events in its peacetime history. The fires that erupted on February 7th in Victoria, the second-most populous state, killed more than 180 people. Police say the toll could reach 300. The final count will be left to authorities with the grim task of sifting through landscapes blackened by flames so ferocious that they melted car parts and devoured buildings in seconds.

In one of Australia's hottest summer seasons on record, about 50 fires also raged across New South Wales, the most populous state, without loss of life. But it was neighbouring Victoria that bore the most devastating brunt. The state is prone to hot winds driving in from deserts, fanning flames whose "scale and savagery", says Stephen Pyne, an American fire expert, "have no equal elsewhere on earth."

This week's fires easily outstripped the worst two previous ones: "Black Friday" in January 1939, when 71 people died in Victoria; and "Ash Wednesday" in February 1983, which took 75 lives in Victoria and neighbouring South Australia. This time, a prolonged drought gripping south-east Australia, and temperatures staying above 40°C for days, made for a lethally dry terrain to fuel the flames.

More than 30 fires spread from Horsham, in western Victoria, to the Latrobe Valley in the east, burning out 360,000 hectares (868,000 acres). The worst raged in a mountainous region only 70km (43 miles) north of Melbourne, and almost wiped out Kinglake and Marysville, two idyllic old towns; up to one-fifth of Marysville's 500 residents might have died. Ian Pearson, a Marysville survivor, described the town now as "the inside of hell".

As firefighting crews battled the blazes, authorities blamed arsonists for starting some, and even relighting others that had been brought under control. Police have arrested two suspected looters and are treating some locations as crime scenes. After touring Victoria for two days, Kevin Rudd, the prime minister, called the deliberate lighting of fires "mass murder".

Australians put aside their obsession with grim economic news, and responded to one of their country's worst natural disasters with a mixture of grief and grit akin to wartime. They donated almost A$34m ($22m) to help ravaged communities and about 5,000 people left homeless, on top of A$15m Mr Rudd pledged.

Fires, floods and drought are part of Australia's national legend: "her beauty and her terror", as Dorothea Mackellar wrote in a 1908 poem recited by every Australian schoolchild ever since. Yet the human cost of this catastrophe shocked even fire experts. A commission of inquiry set up by John Brumby, Victoria's premier, will examine Australia's fire-management strategy. Controlled burning in cooler months, to reduce fuel loads, was given up in many places after city people protested about smoke hazes. The government of Victoria's advice to people in fire paths—leave early or fortify properties and stay—seems to have unravelled. Kevin Tolhurst, a Melbourne ecologist, suggests many were overwhelmed, fled at the last minute—"the worst time"—and were trapped.

Debate has started, too, about the fire's intensity. Some are linking Australia's heatwave and decade-long drought to climate change. In a report to Mr Rudd's government late last year Ross Garnaut, an economist, forecast that the number of days each year in Melbourne hotter than 35°C will rise from nine now to 21 in 2070. He said fire seasons were projected to start earlier, end later and be more intense. Mr Rudd has promised that shattered townships will be rebuilt "brick by brick". It may also be worth considering precisely where and how they should be built.

America and Afghanistan

Changing the guard in Kabul?

Feb 12th 2009 | KABUL
From The Economist print edition

America is debating whether to stick by Hamid Karzai. The stakes are high

THE Afghan guard of honour, in green uniform and white gloves, formed an orderly line at Kabul's presidential palace, Arg-e-Shahi, as snowflakes drifted down through the smog onto their gold braid. It would be some hours before they welcomed Ban Ki-moon, the UN secretary-general. But beforehand the guards had to line up for a different sort of inspection: passing through a metal detector; being frisked; and placing their rifles through an X-ray machine to make sure they were unloaded. One can never be too safe when it comes to the security of Hamid Karzai, the target of many an assassination attempt during his seven years as president.

EPA

Karzai and his well-frisked guard of honour

American policy in Afghanistan, resting on the idea of bolstering Mr Karzai's government, has been one bullet away from disaster. But as the Taliban surge back with every year of fighting—this week insurgents killed at least 20 people in attacks on three government buildings in Kabul—the Americans are starting to think that the real problem may be Mr Karzai himself.

The Afghan president had enjoyed cosy fortnightly video conferences with President George Bush. Under Barack Obama, these have ended. Indeed, Mr Obama's team has been critical of Mr Karzai. As chairman of the Senate's foreign-relations committee, Joe Biden, now vice-president, walked out last year from a dinner given by Mr Karzai, fuming at his host's evasions about opium-fuelled corruption. Hillary Clinton, secretary of state, has referred to Afghanistan as a "narco-state".

Mr Karzai has taken to scrutinising foreign news reports to identify his detractors. He has become strident about the killing of civilians by foreign troops. During Mr Ban's visit he said that the Americans were putting pressure on him to keep quiet "but that is not possible". At a graduation ceremony for the first batch of Afghan military cadets last month, he demanded that America give him planes and tanks, "otherwise we will get them from the other place"—ie, Russia. Asked at a security conference in Munich last weekend whether the Americans wanted to dump him, Mr Karzai told a German newspaper: "The Afghans determine who leads Afghanistan…We are not a colony."

The stirrings of anti-Western sentiment worry NATO commanders as they prepare for a big effort to push back the Taliban, with the expected arrival of 15,000-30,000 American troops this year. Mr Biden is said to have warned Mr Karzai privately last month to "knock it off". In public, though, NATO puts on a brave face. "I compare it to a marriage," says Brigadier-General Richard Blanchette, spokesman for the NATO-led International Security Assistance Force (ISAF), echoing similar comments by Mr Karzai. "After seven years you may hear the couple speaking in loud voices but the exchange is not necessarily negative."

Perhaps so. But Richard Holbrooke, America's special envoy to Afghanistan and Pakistan, was visiting the

region this week to decide whether to seek a divorce. Before his appointment he had pointed to “massive, officially sanctioned corruption” as one of the country’s biggest problems. As a diplomat, though, he may be more cautious about unseating Mr Karzai. Mr Holbrooke told the Munich conference that resolving the problem of Afghanistan would be “much tougher than Iraq”. Moreover it had to be tackled not just in Afghanistan but together with the worsening turmoil across the border in Pakistan; the policy must deal with “AfPak”, he says. He will no doubt have to consider even wider regional implications, including relations with Iran. Moreover, Kyrgyzstan has announced its intention to close the American base at Manas, apparently under pressure from Moscow (which in turn promises to allow NATO’s non-arms supplies to pass through Russian territory, and is even considering offering its own military aircraft to help resupply NATO forces).

Under review

No decisions will be taken at least until NATO’s summit in April. President Obama has ordered a policy review, to be conducted by Bruce Riedel, a former CIA officer. He will draw in part on three studies—by the White House, the Pentagon and officers at US Central Command—ordered by the outgoing Bush administration. One thing seems certain, however. Mr Obama looks just as determined as Mr Bush to keep up the drone and guided-rocket strikes against suspected al-Qaeda targets in Pakistan’s tribal belt. “I am not going to allow al-Qaeda or Osama bin Laden to operate with impunity, planning attacks on the US homeland,” he said this week.

The question for America is the degree to which fighting al-Qaeda requires an ever-growing garrison and wholesale state-building in Afghanistan—and whether Mr Karzai is a help or a hindrance. If America were minded to unseat him, it would probably have no better opportunity than the looming constitutional crisis. Afghanistan’s election commission has delayed presidential elections until August, by when more American and Afghan troops should be available, and the fighting season should have peaked. But Mr Karzai’s term expires in May and the constitution makes no provision for a postponed ballot. The president clearly intends to stay in office and stand for re-election, but parliament long ago turned hostile. The speaker of the lower house, Younus Qanuni, insists that Mr Karzai should step down in May. Ramzan Bashardost, a maverick former minister of planning who has been holding court in a tent outside parliament, says that if Mr Karzai stays on it would be tantamount to a coup d’état.

Some Western diplomats think opposition leaders are unlikely to press too hard to unseat Mr Karzai because they are not ready for elections. They would not agree who should take over, even in the interim. And Mr Karzai’s removal would probably force the resignation of the defence and interior ministers, and of the intelligence chief, creating a vacuum ahead of what is likely to be an intense fighting season.

Kai Eide, the UN’s representative in Afghanistan, says he is “very worried” by the furore, and thinks Afghan and Western governments should tone down their rhetoric: “Afghanistan cannot afford a more tense relationship with its main troop-contributing countries, and cannot afford a constitutional crisis; it certainly cannot afford both at the same time.”

The trouble with Karzai

Charismatic and conciliatory, Mr Karzai was once the darling of the West. Under him progress has been made, not least in extending basic health services and education and in creating a well-liked Afghan army. But as the fighting has intensified and spread—insurgent attacks were up by a third and civilian casualties increased by 40% last year over 2007—opinion of Mr Karzai has darkened. He is now seen as indecisive and a poor administrator, using his “pocketful of mobile telephones” to deal with endless petitioners rather than running a proper government. He now has a more able team of ministers, notably those dealing with security. But his presidential staff is still deemed incompetent.

Afghan leaders mainly blame Pakistan for the insurgency. But many believe it is being fuelled by a sense of injustice, the exclusion of some tribes from power and by corruption. An American commander says that instead of seeking “to serve and to protect”, the Afghan police works “to exploit and to extort”.

Babrak Shinwari, an independent (ex-communist) member of parliament, describes Mr Karzai as weak. "Security is getting worse day by day," he says. "If the president is not changed we will have a big war in Afghanistan, like we had in Russian times."

In many eyes, Mr Karzai's greatest shortcoming is his failure to assert his authority over his younger half-brother, Ahmed Wali, whose grip on the tribal politics of Kandahar has antagonised many. Diplomats speak of "towering rows" between the two. But Mr Karzai cannot win an election without the help of his brother's network among the southern Pushtun tribes.

Gauging opinion is particularly inexact in Afghanistan. Yet some broad trends are apparent from two opinion polls, one published in October by the Asia Foundation, an American NGO, and one this month by three broadcasters, including the BBC. Both surveys found that the number of people who thought Afghanistan was going in the "right direction" had dropped over recent years while those who thought the opposite had grown; optimists and pessimists were roughly even. Of those who said things were going badly, about half cited growing insecurity and violence, followed by corruption and poverty.

The broadcasters' poll also found that support for Mr Karzai has been falling, although 52% still thought he was doing a good or even excellent job (some analysts say his true support is much lower). The standing of Western forces was also in decline (just 33% thought they were doing a good or excellent job) although the Taliban and foreign jihadists were highly unpopular. The real vote may depend less on personal choices than on the wishes of local strongmen. If Mr Karzai runs as incumbent, he is thought to have enough money, patronage and tribal alliances to win once again. "He can only win if he cheats, and he can only cheat if he is in office," claims an Afghan businessman.

Strangely, given Mr Karzai's declining popularity, few prominent rivals have yet announced their intention to run. And in truth, it is hard to think of a candidate who is obviously more appealing than Mr Karzai. The conventional wisdom is that Afghanistan needs to be led by a Pushtun with credibility among the southern tribes (Mr Karzai's Popolzai are linked to royalty) and, ideally, acceptable to Pakistan.

Mr Qanuni, who came second in the last presidential ballot, and the former foreign minister, Abdullah Abdullah, are regarded as able. But the former is a Tajik and the latter, although claiming some Pushtun roots, is closely associated with the Tajiks. Other names that are often mentioned include Ashraf Ghani and Ali Jalali, both Pushtuns living in America who once served under Mr Karzai, as finance and interior ministers respectively. But many believe that Afghan exiles, no matter how able as technocrats, lack credibility; Mullah Omar, the Taliban leader, calls them "dog-washers". Such misgivings would be even more true of a man the subject of much intriguing speculation: Zalmay Khalilzad, a former American ambassador to Afghanistan, Iraq and the United Nations, who is said to have put out feelers about running. Would any of these have what it takes to play the tribal game and, as a businessman puts it, "kiss bearded guys who have never brushed their teeth"?

Reuters

Show me the way to go home

One who certainly could is Gul Agha Sherzai, a former warlord and governor of Kandahar, a successful governor of Nangarhar, now largely free of opium poppy. When Mr Obama visited Afghanistan last year, Mr Sherzai was the first Afghan leader he met. But the governor would be a brave choice. Diplomats describe him as a controversial figure, and speak of many (unproven) lurid stories about him.

Nature abhors

Some would like to see a grand multi-ethnic coalition take on Mr Karzai. One idea that is gaining ground is to change the constitutional balance by, say, creating a prime minister who would share authority with the president. This might offer an elegant way of stripping Mr Karzai of power while honouring him as a "father of the nation", and reassuring him about his family's safety and the interests of the Popolzai.

Such a move, however, would require prolonged bargaining and a further postponement of the elections. This could allow other problems to be tackled, not least the devolution of some central-government powers to the provinces, which at present cannot raise funds or set spending priorities. It might also allow Mr Holbrooke to negotiate a new regional compact which, if successful, might help stabilise Afghanistan. A new dispensation may also help entice at least some Taliban commanders over to the government's side.

But the risks are obvious. The time-consuming effort to reach a more ambitious political settlement could create a bigger and more dangerous vacuum, with even less certainty that it will be filled by anything more acceptable than Mr Karzai.

Sri Lanka's war

To the bitter end

Feb 12th 2009 | COLOMBO
From The Economist print edition

The war's grim last chapter

Reuters

Fleeing danger for uncertainty

GAUNT, wide-eyed and layered with grime, hundreds of civilians have started stumbling out of the diminishing patch of northern Sri Lanka that Tamil Tiger rebels continue to defend. Images released by the army show exhausted men, women and children clutching meagre belongings stuffed into schoolbags, sacks and weathered suitcases. Few wear shoes or slippers. Their feet are dusty and cracked from the trek into government-held areas.

Some have injuries but there is no saying which side inflicted them. With fighting between the government and the Liberation Tigers of Tamil Eelam reaching a fierce climax, civilians and the truth are both casualties of war. Journalists have no access to the battlefront or to the displaced and must depend on information released by the government or the Tigers.

According to army records, more than 30,000 out of an estimated 250,000 civilians have streamed out of Tiger territory this year. The exodus has been particularly heavy this week and Gotabhaya Rajapaksa, the defence secretary, said a sense of self-preservation will cause the others to surge out more rapidly. If the fighting doesn't force them out, shortages of food, drinking water and other essentials will.

The army maintains that frantic rebels have intensified efforts to retain non-combatants as "human shields". On February 9th a woman travelling with displaced people blew herself up when about to be searched by soldiers manning the entry point at Vishwamadu. Ten civilians, including a four-year-old girl, and 19 soldiers were killed. The government said it was a desperate attempt by the rebels—who did not comment on the bombing—to prevent civilians from deserting them.

On February 10th the Tigers reportedly sprayed bullets into a crowd of people heading towards government areas, killing 19 and injuring at least 75. Udaya Nanayakkara, the army's spokesman, said 1,057 civilians had later made it out with the bodies of the dead. On the pro-Tiger TamilNet website, C. Ilamparithy, a rebel leader, denied involvement in the incident. He said commandos from the army had entered their territory and opened fire. The Tigers have repeatedly accused the army of wilfully shelling civilian-populated places, of starving them of supplies and of bombing hospitals. The claims are unverifiable.

Amnesty International, a human-rights group, said in a statement that hundreds of civilians have now lost their lives. Its Sri Lanka expert, Yolanda Foster, gave warning that, "in a war with no witnesses, it is the civilians who pay the price for both parties' disregard for international humanitarian law." The International Committee of the Red Cross, which still has a presence in the war zone, also called for restraint. It said civilians had died in the bombing of hospitals and makeshift medical centres but did not apportion blame.

In government-controlled areas, civilians are registered, “sorted” and placed in camps. Their movement is restricted and they are watched closely for suspicious activity. They are also uncertain of their fates at the hands of an army that has to root out rebels lurking among them. The authorities say they will eventually be resettled but that security concerns must be dealt with, “for everyone’s sake”.

Taiwan's economy

Mirror, mirror on the wall

Feb 12th 2009 | TAIPEI
From The Economist print edition

The ugliest economy of them all?

WHICH economy has been hit hardest by the global slump? In its back pages and on its website *The Economist* tracks 55 countries each week. Based on industrial production, Taiwan has suffered much the biggest shock. Output fell by 32% in the 12 months to December; in the fourth quarter it plunged at an annual rate of 62%. GDP figures, due on February 18th, will be grim.

Taiwan is one of the world's most export-dependent economies, making many high-tech gadgets for Western consumers, so it has been battered by the slump in global demand. Exports plunged by a record 44% in the year to January. The slide in exports has been exacerbated by a drying up of trade credit. This partly explains why imports also fell by 57% over the period. Exports may therefore partly recover as credit improves. But Taiwan's competitiveness has been eroded by its relatively strong currency. The New Taiwan dollar has appreciated by more than 40% against the South Korean won since the start of 2008.

Exports to China have declined by 59% over the past year, twice as fast as exports to America. Sales to China (over one-quarter of the total) consist largely of electronic components, and have been hit by massive Chinese destocking. The island's electronics industry is enduring its worst-ever slump. Cheng Cheng-mount, a Taipei-based economist with Citibank, points out that Taiwan's mainstay exports, such as flat-screen monitors and semiconductors, were in oversupply even before the global financial crisis. Now, he estimates, Taiwan Semiconductor Manufacturing Company, the world's biggest contract chipmaker, is running at around 35% of capacity.

Falling exports have, in turn, squeezed domestic spending. Unemployment rose to a six-year high of 5% in December, and the true picture may be far bleaker. Taiwanese companies tend to wait until after the lunar new year holiday before swinging the axe. Average wages have also fallen by 5% in real terms over the past year. Many companies are ordering employees to take unpaid leave. The volume of retail sales slumped by 11% in the year to December.

Even before the financial crisis, household spending had seen the weakest growth rate among the East Asian tigers. One reason is that people with the spending power are elsewhere. Over the past eight years, around 1m Taiwanese business executives, who form much of the island's moneyed managerial class, have moved to China to run factories there. Several economists are now forecasting that Taiwan's GDP will contract by 3% or more this year, which would be the steepest downturn in Taiwan's history. By far the gloomiest is CLSA, a broking firm, which is predicting a horrendous 11% drop in 2009.

To prop up the economy, the central bank has cut interest rates six times since September, to 1.5%. The government also plans a fiscal stimulus of infrastructure investment, consumer handouts and tax cuts worth around 3% of GDP in 2009. To boost consumer spending, the government is giving each citizen a voucher worth NT$3,600 ($106). But many economists are sceptical about whether this will produce much new spending. According to Chen Miao, an economist with the Taiwan Institute of Economic Research, a similar cash-handout scheme in Japan resulted in only 30% of recipients spending more than they had already planned. Anecdotal evidence so far paints a brighter picture. Department stores and supermarkets reported that sales over the lunar new year holiday were 10-20% higher than in 2008.

In the longer term, improved ties with China will benefit the economy. For example, says Mr Chen, more direct flights between Taiwan and China should help. If Taiwan-based businessmen came home every quarter instead of every six months, it could boost ailing consumption. For now, however, Taiwan's

frightful economic news is more likely to encourage households to save rather than spend.

Drought in northern China

The rainman comes

Feb 12th 2009 | YANGBEI, HENAN PROVINCE
From The Economist print edition

Farmers pay the price for decades of wasteful water use

AP

Mr Wen sprays largesse, too

AS CHINA'S 15-day lunar new year holiday began, Wen Jiabao, China's prime minister, was in the plush Swiss resort of Davos, hobnobbing with other global powerbrokers. Towards the end of the holiday on February 8th, he appeared in a very different setting. Sporting a pair of smart white trainers, he strode through a grain field in the village of Yangbei, Henan province. He squatted down to talk to local farmers to offer them help to see them through a severe drought that now plagues Henan and six other provinces in northern and central China.

After 100 days without precipitation in the region, the government has declared a "Level 1" emergency for the worst drought in 50 years, authorising an extra 300m yuan ($44m) in special drought-relief spending. It will finance everything from cloud-seeding rockets to the digging of new wells and tankers to deliver water. This year's winter-wheat harvest is at risk. February 8th saw some rain, but only 5-10 millimetres, compared with 200mm farmers say they need in coming months.

The drought comes at a difficult moment. The global downturn has hit China's exporters hard, and millions of rural migrants have lost their jobs in coastal factories and returned to their villages. Mr Wen pleased local farmers with what he had to say. They have already received help from the government, which last year invested in a new deep well. Like many of her neighbours, Fang Yue-ling, a farmer, was confident such high-profile promises would presage more assistance.

About 250km (150 miles) to the north, in neighbouring Shanxi province, in Pingdong, a much poorer village, 250 people live along battered dirt roads, and try to grow wheat, corn, soyabeans and winter melon on the dry, rocky mountain land. There, Guo Yongxin says he knows nothing of the government's drought-relief campaign. "We rely on the heavens for our water and we know it won't come to us from any place else." He says Pingdong is lucky because, unlike some other places, at least it has enough water for drinking and daily life. But this year, it is not enough for farming. He reckons his harvest this year will at best be half of last year's.

Such water scarcity is nothing new for this part of China, and neither is government attention to the issue. The region is home to the Red Flag Canal, a massive water project. According to the official tale told at the elaborate commemorative museum near Linzhou, workers, using little more than hand-tools, took all of the 1960s to build the 1,500km waterway and its 462 reservoirs and ponds. The "Red Flag Canal Spirit" has ever since been held up as a shining example of self-reliance, socialist solidarity and selfless devotion.

As population and living standards rise, such virtues will not be enough. China's water woes will only worsen, especially for farmers. When supplies tighten, urban and industrial users usually have priority. Ma Jun, a water specialist in Beijing, says that since the 1950s China has been digging ever deeper wells, and building ever more dams, canals, and water diversion projects. But all this has taken a toll. Because of

lower water-tables and depleted aquifers, many rivers can no longer replenish themselves in the dry season. The government’s current emergency measures are necessary in the short term. But he argues that in the long term the focus must shift to conservation, efficiency, and more rational pricing so that city users pay their fair share. He concedes the Red Flag Canal is a “genuine miracle” and that there is a role for other grand projects. But, looking ahead, he argues that, in China’s ability to go on tampering with its natural-water resources, “we have reached our limit”.

South Africa's economy

Tough times ahead

Feb 12th 2009 | JOHANNESBURG
From The Economist print edition

But Africa's biggest economy may still recover quickly from a looming recession

Reuters

ANY lingering hopes that South Africa might escape relatively unscathed from the global economic storms were dashed on February 5th when Tito Mboweni, governor of the central bank, predicted that Africa's biggest economy would go through "a rough patch for the next three to four years". Any politician who did not pass on that message to voters was "living in cloud-cuckoo-land".

The same day, in an attempt to stimulate the economy and mitigate the effects of a recession, the bank chopped interest rates by a full percentage point to 10.5%, the biggest single reduction since 2003. As Mr Mboweni confessed at the time, he personally would have preferred a two-point cut. This week he signalled that if growth figures for the last quarter of 2008, due out on February 24th, were worse than expected, there could be a further cut in rates ahead of the monetary-policy committee's next scheduled meeting in April.

Like the rest of Africa, South Africa had until recently been doing relatively well. Between 2004 and 2007, its economy grew by a perky 5% a year, after averaging a still respectable 3% over the previous decade. Last year it had been expected to expand by around 4%. But after slowing to a virtual standstill (up just 0.2%) in the third quarter—its worst performance in a decade—it will be lucky to reach 3% for the whole year. In the final quarter, the economy probably actually shrank, by as much as 4.6%, some economists reckon.

This shows that, unlike the rest of the continent, South Africa's relatively sophisticated and open economy is exposing the country to the full wrath of the global crisis. There is now a serious risk that South Africa, hitherto fairly well protected by its well-regulated banking system from some of the squalls, will follow its main trading partners in America, Europe and Japan into a technical recession—two successive quarters of negative growth—for the first time in 17 years.

Almost every day seems to bring more bad news. Manufacturing, mining and the retail trade, which together account for more than one-third of South Africa's GDP, are already formally in recession. Last month, new car sales plunged by 35%, the biggest drop in 25 years. The property market, in the doldrums for the past two years, is preparing for an even worse year ahead. Meanwhile, shrinking world demand and plummeting commodity prices have resulted in a sharp dip in South Africa's exports.

So companies have begun to announce big lay-offs as demand falls and factories close. The official

unemployment figure already stands at 23% (unofficially it is probably 35% or more) and is set to rise. Between 2003 and 2007, some 500,000 new jobs were being created every year. This year around 250,000 jobs are expected to be lost, so millions more will sink below the poverty line. Of the 4m officially deemed jobless, only just over 500,000 are eligible for unemployment benefit.

Still a rainbow country of extremes

Since the ruling African National Congress (ANC) came to power in South Africa's first democratic elections in 1994, absolute levels of poverty have declined. But the discrepancies in wealth are still huge despite government job-creation schemes and the expansion of welfare benefits. The income of the top 10% of the population (still predominantly white but including a growing number of middle-class blacks) is nearly 100 times that of the bottom 10%.

Exacerbating the uncertainty over the country's economy are the national and provincial elections which, President Kgalema Motlanthe announced this week, will be on April 22nd. The ANC is bound to win. But there is concern about a possible leftward shift in economic policy under Mr Motlanthe's successor, Jacob Zuma. As the ANC's leader, he will be ruling in alliance with the South African Communist Party and the Congress of South African Trade Unions, better known as COSATU, the country's main union federation.

Are such fears justified? The ANC's election manifesto, which reads more like a wish list than a set of firm pledges, is too vague to indicate exactly what direction the new government will take. Mr Zuma, who is almost certain to be the next president despite his continuing legal problems (he is facing trial for corruption), insists there will be no radical shift to the left. But he recently hinted at a more interventionist approach, declaring that the "days of the state remaining aloof from the market are now gone".

Many will be looking to see whether the well-regarded Trevor Manuel, South Africa's finance minister since 1996, will keep his job. It was largely because of his prudent macroeconomics that government debt was slashed (from 48% of GDP in 1994 to 31% in 2007) and that South Africa achieved its first-ever budget surplus in 2007-08. Though that trend will now be reversed (he has just announced a budget deficit of 3.9% for 2009-10), it has given the government some useful wiggle room. Mr Manuel has gained an almost mythical status for competence and integrity among foreign investors. His high (fourth) place on the ANC's recently announced list of candidates suggests Mr Zuma will want to keep him on. Whether Mr Manuel will agree is another matter.

Although South Africa's economy has been taking a severer battering than expected, it may still be better placed than many others to weather the storms. On the bright side, the banking system looks healthy. Inflation, in double digits for most of last year, is projected to sink to under 6% this year and next. Interest rates are expected to keep falling; though this may further weaken the rand, it should help South Africa's exports.

All this, along with plans to spend 787 billion rand ($79 billion) on infrastructure, including preparations for hosting next year's World Cup for football, may, with a bit of luck, let the economy pick itself up fairly fast once the world crisis begins to pass. Mr Manuel predicts growth of 1.2% this year, 3% next year and 4% in 2011.

Zimbabwe

A unity government, at last

Feb 12th 2009 | JOHANNESBURG
From The Economist print edition

But is President Robert Mugabe genuinely ready to share any power?

FEW seriously believed it would, or could, really happen. On February 11th, almost a year after elections which saw Robert Mugabe's ruling Zanu-PF party defeated for the first time since independence in 1980, Morgan Tsvangirai, leader of the Movement for Democratic Change (MDC), was sworn in as prime minister. It is a post reinvented for the leader of the country's main opposition party under a deal in which Mr Mugabe is meant to share power.

Up until the last moment, there had been doubts as to whether Mr Tsvangirai would actually agree to enter the unity government. Several of the conditions he had set for taking part in it had not been met, such as the release of about 30 MDC and human-rights people, abducted, tortured and detained. But in the end, he seems to have decided that a bad deal was better for Zimbabwe's wretched people than no deal at all. He, unlike Mr Mugabe, refers to the government as "transitional", regarding it as a precursor to fresh elections.

Under the power-sharing pact, which Mr Tsvangirai signed on January 28th, the MDC will get 13 cabinet posts in a 31-member government and Zanu-PF 15, though it holds fewer parliamentary seats. The remaining three posts go to an MDC splinter led by Arthur Mutambara, who also becomes a deputy prime minister. Thokozani Khupe, the MDC's vice-president, was sworn in as another deputy prime minister. The hotly contested home-affairs ministry, which oversees the police, is theoretically to be shared between the MDC and Zanu-PF. Mr Mugabe keeps control over the armed forces. Tendai Biti, a fiery human-rights lawyer and the reputed brains behind the MDC, is handed the unenviable task of running the finance ministry.

Mr Tsvangirai's decision to get into bed with the despotic Mr Mugabe has been much criticised, not least in his own party. There has been talk of a power struggle between Messrs Tsvangirai and Biti, who has openly opposed the deal. He says it was forced through by the Southern African Development Community, a 15-country regional group he accuses of gross bias in Mr Mugabe's favour.

AFP

A hugging or a mugging?

Outsiders, including most of Zimbabwe's would-be donors and investors in the West, are sceptical too. How can two such bitter enemies ever work effectively together? Many fear the MDC leader will end up being used as a scapegoat for the country's continuing ills, leaving Mr Mugabe, who turns 85 on February 21st, in control of all the levers of real power. Ominously, the pact gives the president the right to fire his prime minister for incompetence. A 12-member committee, consisting of four people from each of the three parties, is meant to monitor compliance with the deal and resolve any disputes. But it may prove toothless.

Small wonder that big donors like Britain and America say they want to see how the new government performs before deciding whether to resume aid. But without outside money, even with Mr Biti and the MDC in control of the finance ministry, the new government has the most daunting of uphill tasks.

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Uganda

A country adrift, a president amiss

Feb 12th 2009 | KAMPALA
From The Economist print edition

The government fails yet again to defeat the Lord's Resistance Army

WHEN Uganda's president, Yoweri Museveni, came to power in 1986 after a long bush war, he promised a sea change for his landlocked country: peace and security for all, democracy, prosperity and frugal governance. He made a point, then, of lambasting the "pathetic spectacle" of rotten African leaders flying to summits in executive jets. In 2001 he promised to serve only the two terms provided for by the constitution. In 2005 he reneged by changing the constitution so he could serve a third term. He is likely to run again in 2011, and win.

Judged by his original promises, Mr Museveni has been a failure. The north of the country, terrorised by the rebel Lord's Resistance Army (LRA), has been a blood-spattered mess for two decades—and still awaits a real peace. Democracy has been corroded by the army's continuing power, as well as by Mr Museveni's refusal to relinquish office. The economy is stumbling. Frugality has been trumped by corruption.

A million-plus people, most of them resentful Acholis, still live in squalid camps in the north. The monstrous ragtag militias that drove them out of their villages are still at large; a recent military campaign against the LRA in neighbouring Congo has been indecisive. Troops from Uganda, Congo and South Sudan, backed by Ugandan air raids and American intelligence, hammered the LRA's camps towards the end of last year. But, like mercury, the LRA fighters slipped away through the jungle in several directions, burning villages, butchering hundreds of civilians and kidnapping children to slave for it. The UN's head of humanitarian affairs, Sir John Holmes, says the campaign's result was "catastrophic". The war goes bloodily on.

In the capital, Kampala, you see tell-tale signs of a country struggling to keep up. In contrast to Ethiopia, another regime run by former guerrillas, Uganda has a colourful abundance of mobile phones and banks; its economy has grown steadily in recent years. But the government's hopes that it would grow this year by 9% look fanciful; the real rate may be closer to 4%. Uganda's tax authorities say they are unlikely to meet targets because businesses are flagging. The country is struggling to attract foreign money. Investors often complain that Ugandans are not skilled or hard-working enough. Many of the country's chief executive officers are brought in from Kenya.

Though Mr Museveni is more interested in cows than Bentleys, pilfering by officials has damaged his standing at home and abroad. Western aid-givers say they have lost patience yet continue to pay for a third of Uganda's budget. Mr Museveni is said to have incensed the IMF by buying a new Gulfstream V executive jet to replace his existing Gulfstream just after the fund agreed to its latest debt-relief package.

Uganda should benefit from recent oil finds in Lake Albert, but many worry that its government may spend too much of the cash on the armed forces. That would fit a pattern of indulging the men with guns. Uganda's army is one of Africa's strongest. The police have tripled in size to 40,000 in recent years; the president keeps them sweet by giving recruits paramilitary training, heavy weapons included.

In the longer term, Mr Museveni has ambitions to turn the East African Community (EAC), which includes Kenya, Tanzania, Burundi and Rwanda as well as his own country, into a single-currency trading zone. He has rejected the efforts of the African Union's new year-long chairman, Muammar Qaddafi, an old ally, to move towards what the Libyan leader describes as a "United States of Africa". That would, perhaps, overshadow his own ambition of becoming the EAC's first president.

Yet while Mr Museveni plots his future, he is oddly blasé about other challenges. He has made no effort to groom a successor from within his ruling National Resistance Movement, leaving his wife and son as front-runners. He conflates population growth with market growth. The percentage of Ugandans in poverty remains above one-third, so absolute numbers have risen. The relatively few Ugandans in paid employment are under strain. The fecundity of the land, with its plentiful harvests, may take the edge off political protest for now. But Uganda is drifting, even as its population has grown from 15m when Mr Museveni took office to 31m today.

Iran's presidential election

Back to the future?

Feb 12th 2009 | CAIRO
From The Economist print edition

A belligerent president is at last being challenged by a pragmatic reformist

MAHMOUD AHMADINEJAD, Iran’s president, faces a disgruntled people, an election in June, and now a strong new challenger for his job. This week Muhammad Khatami, a jovial, 65-year-old reformist cleric, who is more softly spoken and gentler-looking than the incumbent, finally decided to throw his turban into the ring. He previously served two terms as president, from 1997 to 2005.

At the time, Mr Khatami’s double electoral triumph was seen as a rebuke to the harder ideologues who had dominated revolutionary Iran’s hybrid theo-democracy. His fractious reformists, however, proved no match for the conservatives entrenched in the power structure. Not only did they block most reforms. They also succeeded in pinning blame for their failure on the reformists themselves and in alienating enough voters to pave the way for Mr Ahmadinejad’s ascent.

Mr Khatami’s return to the fray raises the hopes of the many Iranians who have chafed under Mr Ahmadinejad’s rule. His spendthrift public-works programmes, fuelled by high oil prices and designed to impress the poor, have instead sparked high inflation that has eroded middle-class purchasing power. A harsh clampdown on dissent, combined with tightened rules for “Islamic” behaviour and the belligerent language that has provoked international hostility, have stoked grim memories for many of the darker days immediately after the Islamic revolution of 1979, a time of economic hardship, diplomatic isolation and drastically reduced personal freedom.

Mr Ahmadinejad’s populism still wins admirers and gets the backing of the hawkish security apparatus and the courts. But simmering public discontent and the rising anxiety that has followed the oil-price collapse now worry even his fellow conservatives, to the point where it is not clear whether the president will end up as their favoured candidate in June. Other contenders, such as Ali Larijani, the parliament’s speaker, could get the crucial blessing of Iran’s supreme leader, Ayatollah Ali Khamenei, who has so far favoured Mr Ahmadinejad’s conservatism but has been known to make pragmatic concessions to public opinion in the name of “preserving the revolution”.

The recent softening of Mr Ahmadinejad’s tone regarding Iran’s biggest foreign-policy challenge, relations with America, may be an opening gambit in the looming election campaign as much as it is a simple response to early overtures from President Barack Obama. “The Iranian nation is ready for talks, but in a fair atmosphere with mutual respect,” Mr Ahmadinejad told the crowd in Tehran’s Freedom Square during celebrations for the Islamic revolution’s 30th anniversary, on February 10th. In the same speech, he proclaimed Iran a superpower, trumpeting its development of nuclear and rocket technology as symbols of national virility. Mr Ahmadinejad, it seems, is out to prove that his punchy chauvinism, rather than Mr Khatami’s quiet diplomacy, will win the Islamic Republic its rightful place in the sun.

France and NATO

Back to the fold?

Feb 12th 2009 | PARIS
From The Economist print edition

AFP

Nicolas Sarkozy faces domestic opposition to his decision to return France to NATO's integrated military command in April

IT WAS in a short but scrupulously polite letter to Lyndon Johnson 43 years ago that Charles de Gaulle announced his decision to pull France out of NATO's integrated military command. His country, the French president wrote to his American counterpart, needed "to recover the full exercise of her sovereignty across her entire territory." He shut down NATO's headquarters in Paris and expelled American military bases from France. Ever since, the French have seen their semi-detached status in NATO as a guarantor of their strategic autonomy and a totem of their refusal to accept American supremacy.

President Nicolas Sarkozy's plan to reverse de Gaulle's decision and reintegrate France fully into NATO's military command is, therefore, both bold and unsettling. On April 3rd and 4th Mr Sarkozy and Germany's Chancellor Angela Merkel will jointly host a summit to mark NATO's 60th anniversary. Mr Sarkozy is expected to use the occasion officially to announce France's full return. But he needs to prepare the ground at home for a decision that is contested both by the opposition and by many in his own party. Next week he is expected to make the case in a speech in Paris. The French parliament plans to debate the issue shortly.

For decades, in school textbooks and diplomatic lecture halls, the French have learnt that de Gaulle's decision and the creation of the nuclear *force de frappe* form the cornerstone of France's independent defence policy. NATO came to be regarded with instinctive distrust, as a place in which America and Britain stitched up deals. For their part, the Americans saw France's plans to build an independent European defence capacity as an effort to undermine NATO and create a rival to what the French have termed American "hyperpower". Such mutual mistrust reached its zenith under President Jacques Chirac, who repeatedly called for Europe to be a counterweight to America.

Mr Sarkozy, himself from the Gaullist family but keen to improve France's ties with America, is trying to turn this logic on its head. In his first big foreign-policy speech, he argued that "progress on European defence is in no way part of a competition with NATO." He has repeatedly stressed that the two can be complementary. There are European security concerns, such as in Africa, that NATO would not want to touch. He adds that east Europeans, keen on NATO's security umbrella, will never trust joint European defence as long as they have lingering suspicions that it is a French scheme to weaken NATO.

Mr Sarkozy set three conditions for rejoining NATO's integrated military command: America should drop

its suspicions of joint European defence; progress must be made on this (ie, the British have to get more involved); and France must be given a decent role within NATO. On the first point, he got most of what he needed at the recent Munich Security Conference. Vice-President Joe Biden declared that America would “warmly welcome” a full French return to NATO. He added that “we also support the further strengthening of European defence.”

The second point is trickier. Mr Sarkozy will have trouble pointing to a tangible European defence capacity to show he has got his side of the bargain. Under one symbolic new agreement, a battalion of German soldiers will be based in eastern France. Officials also point to nearly 10,000 soldiers under the European Union flag who are on operations from Kosovo to Congo. But these are ad hoc arrangements. There is no autonomous operational European command headquarters, because the British do not want one, and no money for extravagant institution-building. In the medium term, NATO offers the only serious supranational security structure.

That the French have won a fair deal on the third condition may, however, help to fend off charges that the country is gaining too little in return for rejoining NATO’s integrated command. France seems to have secured two senior NATO posts: one at the allied command in Norfolk, Virginia, and another at the regional command in Lisbon. Mr Sarkozy will stress that France has already commanded NATO missions in Kosovo and Afghanistan. Even when fully within NATO’s military structure, France will still retain its independent nuclear capability and defence autonomy. “My conviction”, Mr Sarkozy said at the Munich conference, “is that France can renovate its relations with NATO while remaining an independent ally, a free partner of the United States.”

All the same, the French president faces broad political resistance. François Bayrou, a centrist, has accused Mr Sarkozy of “abandoning an element of our identity”, and called for a referendum. Dominique de Villepin, a centre-right former prime minister, claims that France will “find itself shrunk on the diplomatic scene”. The Socialist Party has demanded a parliamentary vote as well as a debate, and insists that by fully returning to NATO, France “will lose joint European defence”. Public opinion, however, may be less hostile than the political elite. NATO seems to be little known and little understood. Asked in a poll last year whether France should fully rejoin, 38% said yes, 34% said no and 28% said they were not sure.

In the months ahead, Mr Sarkozy’s greatest political difficulty may be not so much persuading the French of the case of a full return to NATO as dealing with American requests for more help in Afghanistan. The Americans want to double their own presence there, and at the NATO summit President Barack Obama will ask the Europeans to do more too.

France sent an extra 700 soldiers last year. Hervé Morin, the defence minister, says he has no plans to do more. In the past, the French have argued that they are overstretched by commitments elsewhere, notably in Africa. Yet last month they announced that 1,000 French soldiers from Chad and the Central African Republic, and 1,100 from Côte d’Ivoire, would be recalled to France. “We may have put ourselves in a difficult situation because we do actually have some room for manoeuvre now,” comments François Heisbourg, director of the Foundation for Strategic Research. The first test of France’s new commitment to NATO may come quite soon.

A German government shuffle

Taking the Glos off

Feb 12th 2009 | BERLIN
From The Economist print edition

A young upstart, Karl-Theodor zu Guttenberg, replaces Michael Glos

MICHAEL GLOS never wanted to be Germany's economy minister. "I never said, 'What a great job'," he said in an interview last year. On February 7th he chose to leave it in the most awkward manner possible. Seven months before a federal election, in the midst of an economic conflagration, he faxed a resignation letter to Horst Seehofer, premier of Bavaria and head of the Christian Social Union (CSU), which, as a partner in Germany's grand coalition, appoints the economy minister. That stunned Mr Seehofer, embarrassed Angela Merkel, who as chancellor is Mr Glos's nominal boss, and drew attention to the tension between them. Mr Seehofer at first rejected Mr Glos's resignation, then reversed himself when he realised the economy ministry needs a credible boss.

He chose boldly. Karl-Theodor zu Guttenberg, who is 37, is the youngest economy minister since the war. He has blue blood (and ten given names), a way with words and some expertise in foreign affairs. Less apparent are any qualifications for the job. Mr zu Guttenberg ran his family's investment firm, but Mr Seehofer was probably more impressed by his cleverness and glamour. The CSU, which lost its absolute majority in Bavaria last September, needs rejuvenation. Mr zu Guttenberg has just spent three months as the party's general secretary, in charge of preparations for the European and federal elections.

He now has two main tasks: to add heft to the government's management of the economic crisis; and, perhaps more important, to improve the election prospects of the CSU and Ms Merkel's Christian Democratic Union (CDU), the main conservative party outside Bavaria.

The economy ministry itself has lost its heft. It is a catch-all, dealing with technology, energy, competition and small business, often alongside other power-hungry agencies, such as the environment ministry or the European Commission. It had little hand in designing the government's response to the economic crisis but will administer bits of it, including a share of €100 billion ($129 billion) of guarantees to credit-starved enterprises. To Mr Glos's dismay Ms Merkel turned mainly to her finance minister, Peer Steinbrück, for advice on how to fight the crisis, even though his Social Democratic Party (SPD) is the junior partner to the CDU and CSU in the grand-coalition government.

The demands on Mr zu Guttenberg will be contradictory. He must add conservative clout to a crisis-fighting policy with which many conservatives are uneasy. Spending and debt are soaring and the CDU's liberal wing frets that the state is gaining dangerous sway over the private sector. Plans for a minimum wage for temporary workers and to expropriate shareholders in failing banks send chills down liberal spines. Liberals are defecting in droves to the opposition Free Democratic Party. The economy ministry will remain the market-economy "conscience" of the government, promises Mr zu Guttenberg. But Mr Glos had the same good intentions.

Ms Merkel will look to Mr zu Guttenberg for an electoral lift, but he is beholden to Mr Seehofer, who has been one of her main tormentors since taking over Bavaria in October. Keen to show that the CSU still matters in Berlin, Mr Seehofer demanded tax cuts that Ms Merkel was reluctant to concede and torpedoed a reform of green regulations that she had championed when she was environment minister. On February 10th he presented Mr zu Guttenberg to the press in Berlin, alongside the new CSU general secretary and his deputy. The economy minister did not look like his own man. The CDU fears that Ms Merkel's authority is eroding. The SPD, so often split, has mustered a semblance of unity. Ms Merkel remains a strong favourite to defeat the SPD candidate (and foreign minister), Frank-Walter Steinmeier, in September. But the race may yet tighten.

Nuclear power in the Nordic countries

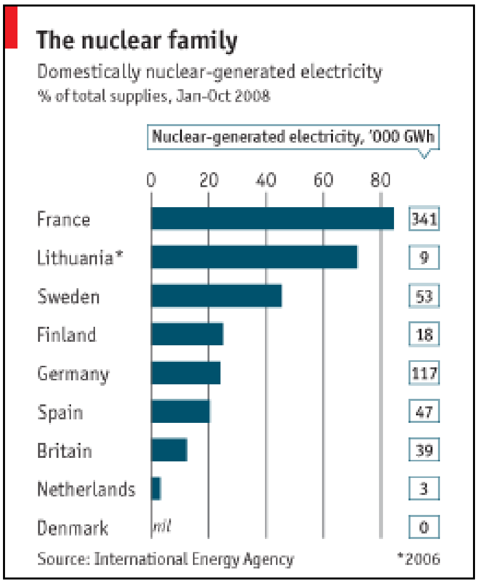
Recalled to half-life

Feb 12th 2009 | HELSINKI
From The Economist print edition

A surprising revival in previously reviled nuclear power

IN WHAT may be his boldest move so far, Sweden's Fredrik Reinfeldt has shredded a central part of the election manifesto on which his centre-right government fought the election in 2006. The four parties in his coalition have long been split over nuclear power. So they agreed in the manifesto to keep all matters atomic off the agenda until their term expired in 2010. But a combination of tight climate-change targets, energy-security worries and a wobbly economy has now caused a rethink. On February 5th Mr Reinfeldt unveiled a plan to reverse Sweden's 30-year ban on building new nuclear capacity.

The new pro-nuclear policy is echoed in some of Sweden's neighbours. On the very day that Mr Reinfeldt announced his proposals Fortum, a Finnish energy group, lodged an application to build a new nuclear plant. This would be the country's sixth. Four are in operation and a fifth (the world's largest) is under construction at Olkiluoto. On the southern shore of the Baltic Sea, Poland plans two nuclear-power stations to reduce its dependence on coal. The Poles are also talking to Lithuania, Latvia and Estonia about a joint consortium to build a replacement for Lithuania's outdated Ignalina nuclear-power complex. Only the Danes and, to a lesser extent, the Germans are still anti-nuclear.



Mr Reinfeldt and his coalition partners should have little difficulty getting the necessary legislation through the Swedish parliament next month. But broad cross-party support would still be desirable to provide stability and ward off any risk of a policy reversal by a future government. So the leftist opposition has been invited to talks to mull over an energy package that also includes measures to cut carbon emissions and boost renewable energy. But like the centre-right, the left is divided over nuclear power: the Social Democrats are split, while the Greens and the Left Party are firmly against.

Jan Björklund, the pro-nuclear education minister, has appealed to the opposition to "throw the battle-axe in the lake" and get on board for the sake of Swedish industry and the climate. But the opposition doubts the sincerity of such appeals. It claims to have been asking the government to discuss energy for almost three years but to have been ignored. "Now they just want us to rubber-stamp a done deal," comments one opposition figure. There are suspicions that the government may be using its nuclear plan as a way of sowing discord within the opposition just as it is trying to formulate a joint platform for the 2010 election.

Whatever the truth, the Social Democrats are unlikely to sign up to a deal involving the construction of as many as ten new nuclear plants. So some shrinking of the government's ambitions may be necessary. But Mr Reinfeldt will not give up without a fight. He has already scored a strategic victory by persuading the Centre Party (a junior coalition member) to revoke its 1980 decision to phase out nuclear power. Maud Olofsson, the Centre Party leader, admits she may not like it, "but we can live with the fact that nuclear power will be part of Swedish electricity production for the foreseeable future."

To Mr Reinfeldt's advantage, many Swedes seem to reason similarly. A Novus Group opinion poll taken after the energy plan was announced found 57% of respondents agreeing that it should be possible to replace old nuclear plants with new. Fully 70% said they thought the government's energy package as a whole was good. But opposition leaders are sceptical. "That poll was commissioned by the pro-nuclear lobby. We have polls of our own and they say something else," says one.

Italy and the right to die

Death in Udine

Feb 12th 2009 | ROME
From The Economist print edition

What the row about Eluana Englaro says about Italy and its political rulers

ON FEBRUARY 6th, at a clinic in Udine in north-east Italy, doctors withdrew nutritional support from a woman in an irreversible coma. Three days later, more quickly than expected, 38-year-old Eluana Englaro died of a heart attack brought on by dehydration.

Reuters

A bright 21-year-old, 17 years ago

Similar things happen every day in other parts of Europe. But in Italy this was a national drama. Outside the clinic, pro-life and pro-choice demonstrators came to blows. On national television, programming was suspended so that Ms Englaro's death could be discussed. In the upper house of parliament, which was debating a bill to keep Ms Englaro alive, there was uproar. "Eluana has been killed," cried a leading member of Silvio Berlusconi's governing People of Freedom (PDL) movement—a phrase the prime minister himself repeated soon afterwards.

The affair highlighted two characteristics of today's Italy. One is the enduring influence of the Catholic church and its teaching on the sanctity of life. The other is its prime minister's impatience with the rule of law.

After a nine-year struggle, Ms Englaro's father won a ruling from Italy's highest appeal court that his daughter should be allowed to die. A key point was that she had apparently stated a preference, before her car accident, for not being kept alive artificially. The Vatican was appalled, seeing the judgment as licensing euthanasia. Mr Berlusconi's health minister and PDL regional officials set about trying to thwart the judgment by bureaucratic means. Until then, Ms Englaro had been in a church-run institution, so she had to be moved. But fear of reprisals deterred most hospitals and hospices from taking her.

On February 3rd, however, she was admitted to the clinic in Udine. Soon afterwards Mr Berlusconi changed tack. His cabinet approved a decree which, had it been countersigned by President Giorgio Napolitano, would have forced Ms Englaro's doctors to continue treatment.

Why? There were no votes to be had. Polls suggested that a large majority of Italians backed Ms Englaro's right to die. Mr Berlusconi scarcely seems like a committed Catholic. Rarely seen in church, he is a divorcee who had the first of his children by his second wife even while he was married to the first. Opponents claimed that he wanted to inflict a defeat on the judiciary ahead of a law reform later this year, and that he also hoped to cow the president as part of a broader strategy aimed at taking over the presidency himself and giving Italy what his admirers say would be a more decisive form of presidential government.

Undaunted, Mr Napolitano refused to sign the decree, forcing Mr Berlusconi to rejig it as a parliamentary bill. Ms Englaro died before it could be rushed through. But Mr Berlusconi had already given a glimpse of the populist side of his political character. "If there were not a chance of resorting to decrees," he said, "I would go back to the people to ask for the changing of the constitution and the government."

Tense relations between Mr Berlusconi and Mr Napolitano may not be the only legacy of this affair. It has also generated widespread parliamentary support for a law that would enable people to draw up "living wills", stipulating how they wish to be treated in the event of losing consciousness. The idea is to avert similar disputes in future. But Ms Englaro was 21 when she had her car accident. Is it likely that she would have made a living will at such an early age?

The western Balkans

A stuck region

Feb 12th 2009
From The Economist print edition

How troubles in Bosnia and elsewhere obstruct the Balkans' path to Europe

"I DON'T want to be the rider on a dead horse." You could hardly describe the situation more bluntly. Since 2007 Miroslav Lajcak has been the international high representative in Bosnia. But late last month he suddenly announced that he was off to become Slovakia's foreign minister. And his undiplomatic language shocked Bosnians even more than his abrupt departure.

Bosnia is not the only western Balkan country that is going through a difficult patch. As it marks its first anniversary of independence, Kosovo remains unreconciled to Serbia (see article). Croatia, Macedonia and Serbia have all run into different obstacles on their long road towards the European Union. But Bosnia may be the most troubled of all.

Mr Lajcak has made clear that the dead horse he had in mind was not Bosnia itself but his own office. On paper the high representative has considerable legal powers to intervene in the running of the country. His predecessors used them extensively. But without muscular backing from the United States and the EU, it is much harder to do this. Mr Lajcak accordingly seems to have decided to jump as soon as he was offered a better job.

Bosnia ticks over on a day-to-day basis, but it seems paralysed when it comes to bigger issues over its future. The EU has been demanding reforms to make it more coherent and efficient, but they have mostly been blocked by Milorad Dodik, leader of Republika Srpska, the Bosnian Serb entity, who is reluctant to cede any more power to the central state in Sarajevo. Nor is he the only leader whom Mr Lajcak deems obstructive. He has often said that its politicians are Bosnia's biggest problem.

Other Balkan countries are little better. Indeed this week Mr Lajcak declared that they were as yet "not mature enough" to join the EU. Croatia, which is the closest to getting in, now finds its path blocked by its former Yugoslav neighbour, Slovenia. The Slovenes are using their veto power as a bargaining tool in a trifling border dispute. Farther south, Macedonia's hopes of moving fast to join the EU (and NATO) have been dashed by the Greeks, who argue that the name Macedonia disguises territorial pretensions to part of the province of Macedonia in Greece. The Macedonians have enraged the Greeks even more by renaming their main highway (like their airport) after Alexander the Great. This may be an electoral ploy before a presidential election on March 22nd—but it reduces the chances of progress in new talks.

Serbia too is blocked. The Netherlands has stymied its planned stabilisation agreement with the EU until Ratko Mladic, a Bosnian Serb general indicted for genocide during the Bosnian war, who is believed to be in Serbia, is caught and sent to The Hague war-crimes tribunal. Undaunted, Serbia's deputy prime minister, Bozidar Djelic, has said that his country will apply for EU candidate status in June. Yet Serbia's neighbour, Montenegro, which has already applied for EU candidate status, is still waiting for a reply. Montenegro's application to join the World Trade Organisation has just been foiled by Ukraine, for reasons that are unclear.

To cap it all, the western Balkans has been badly hit by the world financial crisis. Growth forecasts are down across the region, investors are slowing projects and governments are drawing up rescue plans. So far, the Balkans has escaped the civil unrest seen in the Baltics and elsewhere. But the people of the region can only nurse a sense of grievance when they hear how welcome Iceland would be were it to apply to join the EU—and how quickly it might get in. One despondent senior Serb official might be speaking for all of the western Balkans when he says that "there is a feeling of being stuck."

Kosovo's independence

One year on

Feb 12th 2009
From The Economist print edition

Confounding the sceptics, up to a point

NEXT week Kosovo will be one year old. It was the seventh state to emerge from former Yugoslavia. Sceptics predicted dire consequences: the Serb minority would leave, the region would see a new round of violence, Serbia would fall into the hands of extreme nationalists. Happily, none of this has actually happened.

Unlike the other six former Yugoslav countries, Kosovo was technically a province of Serbia in the old Yugoslavia, not a republic, even though over 90% of its 2m people are ethnic Albanians. That distinction gave Russia an excuse to block a United Nations resolution on Kosovo's status. It also explains why only 54 countries recognise Kosovo's independence.

The greatest success of Kosovo has been to avert a Serb exodus. Kosovo's Serbs live mostly in enclaves or in the north of the country, under de facto Serbian control. They are under pressure from Belgrade not to participate in any of Kosovo's institutions. Yet Serbia now has a firmly pro-European government; in the wake of Kosovo's independence, the extreme nationalist threat has evaporated, not exploded.

After a slow start EULEX, the European Union's police and justice mission, deployed across Kosovo in December. For most of 2008 it was hampered by Serbian opposition and by splits within the EU. The former UN administration, which was meant to leave with Kosovo's independence, has shrunk but not completely disappeared. A 15,000-strong NATO-led force remains.

The bad news is that Kosovo remains poor and its administration weak. Serbia's government has led a highly effective diplomatic campaign against it and Kosovo has a bad image abroad. Yet it is often unfairly singled out for blame. It lies on a main drug-trafficking route, for instance; but so do some EU members, such as Bulgaria and even Austria.

It is widely believed that Albanians, including Kosovars, play an inordinately large role in Europe's drug cartels, but research does not often bear this out. According to a report by the Kosovar Stability Initiative, a think-tank, in 2006 only 6% of those arrested for heroin smuggling in Italy were ethnic Albanians; 65% were Italians and 19% were north Africans. Some stereotypes widely believed and repeated about Kosovars abroad are merely racist.

So are Kosovars downcast? Far from it. A recent survey by the European Fund for the Balkans and Gallup found that, among seven western Balkan countries, Kosovo's people are the most satisfied. They will certainly enjoy their birthday.

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Charlemagne

English is coming

Feb 12th 2009
From The Economist print edition

The adverse side-effects of the growing dominance of English

Illustration by Peter Schrank

LAST summer, on the Atlantic coast of France, Charlemagne was introduced to a fine beach game: building big sand-walls near the shoreline in the face of a rising tide. It is a more thought-provoking activity than building sandcastles, with a nice melancholic tinge. The walls last a surprisingly long time, resisting the lapping tide with the help of energetic patching and fresh buckets of dry sand. But when they fail, they fail quickly. It takes just two or three big waves to signal doom: once water flows behind the defences, even the thickest ramparts are swift to collapse.

European efforts to resist the rise of the English language have now reached the same point. The latest Anglo-surge comes from the European press, with a dramatic increase in the number of heavyweight publications launching English-language websites, offering translated news stories and opinion pieces.

English-language publications aimed at expatriates and tourists have been common for years. But the new development involves big, established national journals, whose bosses want to be more visible in English. *Der Spiegel*, a German newsweekly, has founded a pan-European "network" linking up such websites. A Dutch daily, *NRC Handelsblad*, joined a few months ago, followed by *Politiken* from Denmark. The trio are in talks with newspapers in France and Spain. They are eager to expand into eastern Europe, though the credit crunch is likely to slow progress (an online English edition can cost half a million euros a year in translation fees). Beyond this network, a non-exhaustive trawl finds English-language websites of big newspapers in Germany, Italy, Finland, Greece, Spain, Romania, Poland, Bulgaria and Turkey. Many are recent ventures.

Editors' motives are a mix of idealism and commercial ambition. Bosses at *Spiegel* have a political dream to create a platform where "Europeans can read what other Europeans think about the world," says Daryl Lindsey, who runs the magazine's international edition. But an English presence is also a "calling card" when pitching to international advertisers. It has proved helpful to journalists seeking interviews with world leaders. Kees Versteegh of *NRC Handelsblad* talks of creating a European "demos", but also admits to frustration at publishing some "very fine pieces" in Dutch that the rest of the world never notices.

The evidence points to the imminent collapse of the European Union's official language policy, known as "mother tongue plus two", in which citizens are encouraged to learn two foreign languages as well as their own (ie, please learn something besides English). Among Europeans born before the second world war, English, French and German are almost equally common. But according to a Eurobarometer survey, 15-to-24-year-olds are five times more likely to speak English as a foreign language than either German or French. Add native speakers to those who have learnt it, and some 60% of young Europeans speak English "well or very well".

This is a clear win for English. But paradoxically, it does not amount to a win for Europe's native English-speakers. There are several reasons for this. Start with a political one. European politicians long feared that the use of English in the EU would lead to the dominance of Anglo-Saxon thinking. They were wrong. The example of newspapers is instructive: thanks to English (and the internet), a genuinely pan-European space for political debate is being created. It has never been easier for other Europeans to know what Poles think about the credit crunch, Germans about the Middle East or Danes about nuclear power. English is merely "an instrument", says Mr Versteegh of *NRC Handelsblad*, not "a surrender to a dominant culture."

There is a second reason why Anglophones are not about to dominate European debate: they do not want to. British readers have access to an unprecedented range of news and ideas from Europe in their mother tongue. They show little interest. Only 5% of *Spiegel International*'s readers are from Britain (though half are from North America). In recent years, British newspapers have withdrawn staff reporters right across Europe, and not only to save money. Britain's daily newspapers are less and less interested in European politics and policy. Light, sensational stuff is what editors choose for publication, plus tales of British tourists and expatriates in trouble (a genre known as "Brits in the shit").

Why bother?

Such parochialism may be linked to a fall in language-learning, accelerated since 2003, when foreign languages became voluntary in England and Wales for pupils over 14. That robs them of such benefits as the humility and respect for others that come from learning another language. But given the rise of English, it is rational, says Philippe van Parijs, a Belgian academic.

Under his "maxi-min rule", Mr van Parijs observes that speakers at EU meetings automatically choose the language that excludes the fewest people in the room. They do not use the language best known, on average, by those present (which in some meetings will still be French). Instead, they seek the language that is understood, at least minimally, by all. Thanks to EU enlargement to the east (and poor language skills among British and Irish visitors to Brussels), this is almost always English. That means Britons find it ever harder to justify learning other languages. Even when they do, they have to speak other languages extremely well to avoid inflicting halting French, say, on rooms of fluent English-speakers. And it carries other costs. In Brussels, native English-speakers are notoriously hard for colleagues to understand: they talk too fast, or use obscure idioms.

Mr van Parijs has a prediction: Europeans will become bilingual, except for Anglophones, who are becoming monolingual. In other words, just when the British should be happy, some nasty storm clouds are gathering. You could say it sounds rather like a day at the British seaside.

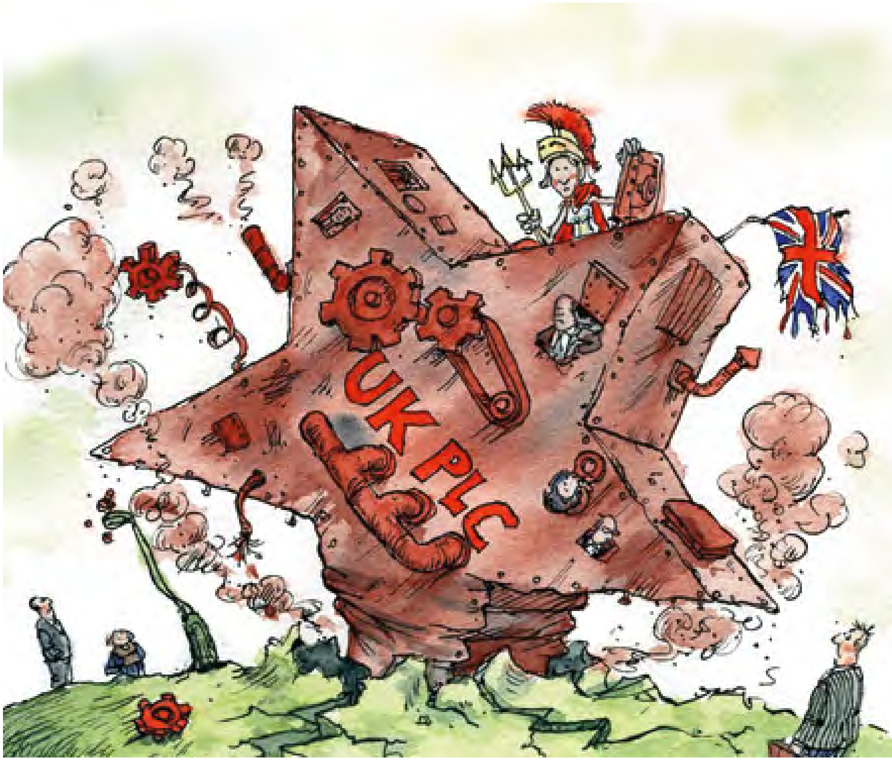
The economy

Britain's fallen star

Feb 12th 2009 | LONDON AND SWINDON
From The Economist print edition

The news goes from bad to ghastly. How awful are Britain's economic prospects?

Illustration by David Simonds



IN SWINDON, a town 80 miles to the west of London which thrived during the boom years now ended, the recession is biting hard. Regent Street is busy on a cold Friday afternoon, but the most favoured shops are those selling cheap goods, such as Poundland, where everything costs just £1 ($1.44). And if Poundland is busy, the government-run Jobcentre Plus in Princes Street is teeming with people looking for work after recent lay-offs.

The rest of the country has run into even greater economic turbulence. For a decade the British economy won plaudits for its good behaviour, not least from foreign investors whose confidence kept sterling strong and stable. Since the global financial crisis began in August 2007, that image has been thoroughly trashed: growth has turned to recession; unemployment is mounting; and the pound has suffered its biggest fall since the 1970s.

What appeared to be a model and well-run economy, expanding steadily for 16 years without inflationary strains, now looks a Heath Robinson affair. It was fuelled by debt—both public and private—and involved a star role for City bankers currently vilified for their excesses. Gordon Brown's boast of ending boom and bust has returned to haunt the prime minister. Economic policymakers at the Treasury and the Bank of England, as well as banking regulators at the Financial Services Authority, are newly humbled.

How justified is Britain's status these days as (some say) Europe's new sick man? It is tempting to see in its fall from grace a simple morality tale: an economy with a swollen financial sector that borrowed a lot, ran a current-account deficit and had a huge housing boom has got its just deserts. But this caricature tells us little, for it is already apparent that supposedly virtuous countries such as Germany, which had current-account surpluses and avoided housing booms, are also in trouble. Among big economies, Britain is neck and neck with Germany and Japan in the race to the bottom, and there is plenty to worry about beyond the downturn. But its swing from paragon to pariah has gone too far.

British exceptionalism revisited

A crisis that started 18 months ago in the City and other financial centres spread to provincial towns like Swindon through a collapse in mortgage finance. The first sector to keel over was residential construction, as demand for new homes dried up. The figures from Swindon are stark. Before the crisis began, roughly 2,000 homes a year were being built; in the year from April 2008 to March 2009 the council expects only 800 to be completed.

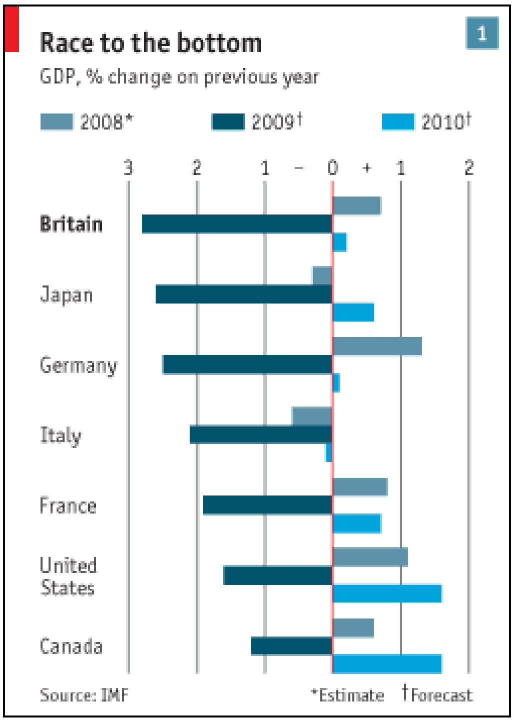
The demise of housing investment is most apparent at Wichelstowe, a development of 4,500 new homes to the south of Swindon. In a buoyant market the builders would be going full tilt, but so far only around 100 homes have gone up, most for publicly supported housing. The developer's flags flutter gallantly in a keen wind by the four show houses of Bryant Homes, a subsidiary of Taylor Wimpey, but it is hard to put a brave face on the fact that it has built only 17 other private homes.

Official figures show that the decline in residential investment was the single most important thing pushing the economy into recession in the third quarter of 2008, when GDP fell by 0.6% from its level in the spring. But since then both the extent of the downturn and its reach have increased dramatically. Output fell by a further 1.5% in the final three months of 2008, the biggest quarterly decline since 1980. Manufacturing was particularly clobbered, dropping by 5.1%—its sharpest fall since 1974.

If Wichelstowe is Swindon's unfortunate showcase for the retreat in housing, the nearby Honda factory at South Marston exemplifies the gravity of the manufacturing setback. On January 30th employees turned up for their final day's work for four months. The factory, which had 4,500 workers when it was running at full capacity and producing 250,000 cars a year, will not reopen its assembly lines until June; and then it will be operating only one shift. Around a thousand workers are leaving voluntarily (helped on the way financially). The remaining employees will receive their basic pay for two months, and then 60% of it in April and May.

A similar story could be told in many countries. Britain was not alone in having a housing boom; Japan and Germany have suffered far more from the recent vicious downdraft in manufacturing, as global demand for the investment goods and vehicles in which their industries specialise has evaporated. Recent forecasts from the International Monetary Fund suggest that GDP will contract this year by 2.6% in Japan and by 2.5% in Germany.

Even so, the IMF tipped Britain for the biggest fall of all the G7 economies, forecasting that its GDP would tumble by 2.8% (see chart 1). This grim outlook was underscored on February 11th by the Bank of England. Its central forecast is that British GDP will shrink by almost 4% in the year to the second quarter of 2009, its steepest decline since the early 1980s.



The gloom reflects growing worries about underlying weaknesses that make Britain especially vulnerable to a recession spawned by the most serious financial crisis since the early 1930s. To start with, its housing boom was among the most extreme, measured by real price increases and resulting overvaluations. Property prices have fallen by around 20% since their peak in autumn 2007, pushing an increasing number of households into negative equity; some reckon prices have the same again to fall. Another bubble, in commercial property, has burst in even more spectacular fashion. Over the past 18 months office blocks and shops and the like have lost more than 30% of their value.

Both these booms were fuelled by debt, another reason why Britain looks particularly vulnerable now. Ten years ago, British households were the fourth most indebted among the G7 economies. By 2002 they had taken the lead, building up a burden equal to 185% of disposable income by the end of 2007. At the same time the public finances swung into the red. Associated with the boom in asset prices and rising indebtedness was a related and pernicious macroeconomic imbalance: a persistent current-account deficit.

A third reason why Britain looks worse off than other countries is the prominence of its financial sector. Although at its peak it accounted for only 8% of GDP, finance has been producing about a quarter of

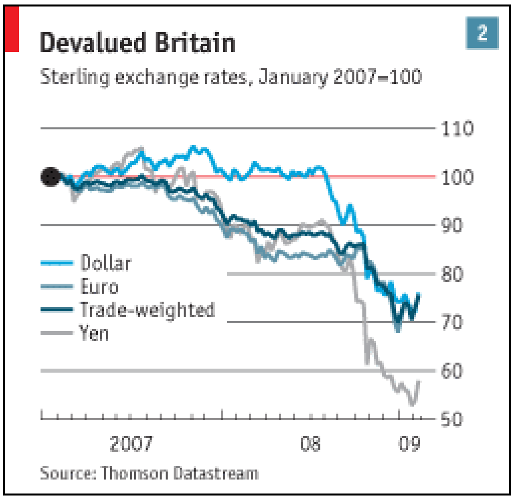
corporate-tax revenues. Once the glory of the economy, the City of London has been hit hard by the credit crunch and its sequel.

So Britain's prospects do look bleak. Experience of past banking crises suggests that countries hit by them suffer deep and long recessions, and generally manage no more than a sluggish recovery. The aftermath of housing bubbles also tends to be unhappy. With Britain's invidious combination of the two, it is easy to see why forecasters are vying to produce the grimmest predictions of economic performance.

Glum, yes—but too glum?

The pessimism may be overdone. Britain has plunged rapidly into recession but it might pull out more steeply too. One reason to think so is that sterling has fallen sharply, its trade-weighted value down by a quarter since January 2007 (see chart 2). Though some see it as a national misfortune, sterling's slide will help to cushion the economy this year and pave the way for eventual recovery. While global trade is in free fall, exports will drop too, despite the weaker pound. But profit margins on foreign sales will improve and, with imports dearer, domestic producers will grab a bigger share of the home market.

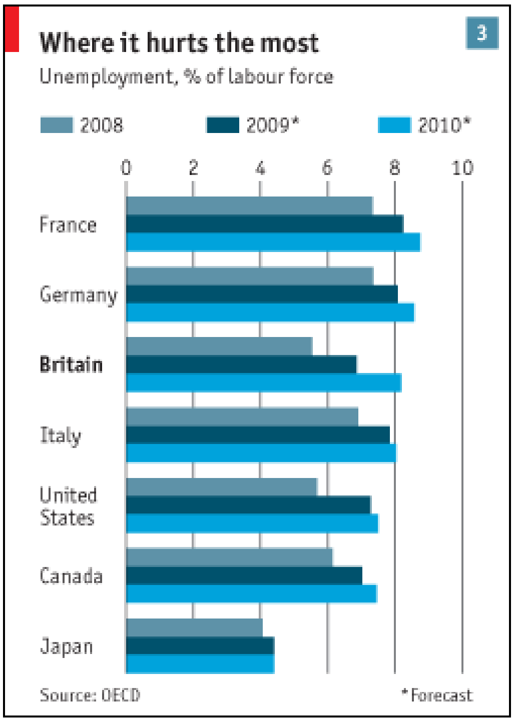
There are other reasons too why some forecasters are less glum. David Miles, an economist at Morgan Stanley, a bank, thinks the economy may shrink this year by just 1.3%—much less than the IMF's forecast—though he concedes that the outcome could well be worse. A crucial issue is what happens to consumer spending, which comprises over 60% of GDP.



Mr Miles accepts that private consumption will fall, but thinks it will be more resilient than many fear. He makes three main points. After being squeezed last year by rising food and fuel prices, households will benefit from the sharp fall in inflation (which is likely to tip into deflation during part of this year). Spending will be boosted by the unprecedented cuts in interest rates since last autumn. And consumers will gain from the temporary reduction in value-added tax, worth about £12.5 billion over 13 months.

The pace of monetary easing also looks set to accelerate. Having cut the base rate to 1% this month (still higher than America's near-zero rate but below the euro zone's 2%), the Bank of England plans to drive down the spread between the yields on corporate and government debt by buying the former. Mervyn King, the bank's governor, said this week that the monetary-policy committee may recommend increasing the money supply by "quantitative easing" in March, though the decision must be authorised by Alistair Darling, the chancellor of the exchequer.

Even with this help is Mr Miles a touch Panglossian? Swindon's busy high street shows that people are still shopping. Yet even if shoppers are out in force, their purse strings are likely to be tightened by rising unemployment. In Swindon the number of people claiming jobless benefit jumped last month to 4,350, over double the claimant count of 1,795 in January 2008. That is a particularly severe outcome: though unemployment is climbing steeply in Britain (see chart 3) it is still lower than in many European countries. But fear of the dole may lead to an increase in precautionary saving.



Falling house prices are another force bearing down on consumption. At Henry George, an estate agency with an office in the heart of Swindon, Robert Skerten says turnover is down 60% on the year before. While they think prices will keep declining, potential purchasers—especially first-time buyers—will hold off, waiting for better deals, says Fionnuala Earley, an economist at Nationwide Building Society, also headquartered in Swindon. That will curb purchases of the big-ticket home goods that people buy when they move.

More controversial is the broader effect of falling property prices on consumer spending. The Bank of England argues that the link

between real house prices and consumption reflects swings in income expectations by households. But others disagree. Declining house prices both reduce wealth and curtail access to credit, says Charles Collyns, deputy director of the IMF's research department: it is one of the main reasons why the fund believes the British economy is especially vulnerable at the moment.

Bankers in the dock

Some fret that things could get even worse. They portray Britain as Iceland writ large, horribly exposed because of its big banking sector and intimate involvement in the sort of global finance that has gone so spectacularly wrong.

This is overwrought stuff. Little Iceland had banking liabilities worth close to ten times its GDP, all piled up by its own banks and mostly in foreign currency. Britain's banking liabilities are equal to some 4.5 times GDP. Over half of these are attributable to foreign-owned banks that have clustered in the City; they hold two-thirds of the British-based banking system's liabilities and assets in foreign currencies. As a result, Britain is much less exposed to a run on its own banks by depositors holding foreign currencies than Iceland was.

And although Britain has exceptionally high external liabilities, thanks to the City's status as the world's biggest international financial centre, it also has very large foreign assets. The gap between the two peaked at the end of 2006, when Britain owed £370 billion—28% of GDP—more than it owned. Since then it has narrowed, helped by sterling's fall (almost all of Britain's external assets are in foreign currency but only around 60% of its liabilities). The gap is now some £150 billion, or 10.5% of GDP—hardly cause for alarm. The current-account deficit has fallen from an average 2.2% of GDP in the ten years to 2007 to 1.6% in the first nine months of 2008.

Yet Britain's banks are ailing. Taxpayers have had to rescue two big ones—Royal Bank of Scotland and HBOS (now absorbed into Lloyds Banking Group)—with emergency recapitalisations, prompting apologies this week from those in charge. The state has also nationalised two mortgage lenders and is proposing to insure banks' toxic assets against catastrophic losses. The questions bothering the markets—and prompting feverish talk in January about national bankruptcy—is how costly all this will prove, and whether the Treasury has the fiscal capacity to pay for it.

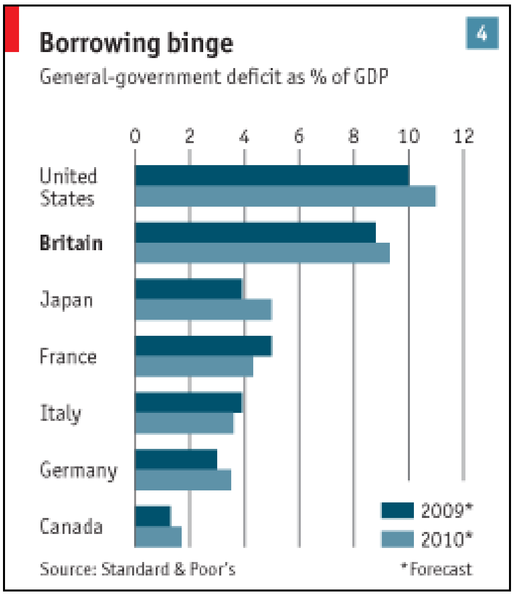
The answer to the first question depends in large part on how deep and protracted the recession turns out to be. Ben Broadbent, an economist at Goldman Sachs, a bank, has estimated that the Treasury's insurance plan for bank assets could cost up to 8% of GDP. If other measures (recapitalisations, support for the two nationalised lenders and the rescue of British depositors with failed Icelandic banks) are included, the bail-out could take around 14% of GDP. That would be a lot more than the cost to Sweden of sorting out its banking crisis in the early 1990s (around 4% of GDP) but in line with Japan's 14%.

If Britain's bill turns out to be more like Japan's than Sweden's, the Treasury would gulp but could swallow it, for Britain's official debt has been relatively smaller than that of other G7 countries. In 2007 Britain's gross government debt was 47% of GDP; in France, for example, it was 70%.

That is no cause for complacency. Even excluding financial bail-outs, public debt as a share of GDP may rise by 20-30 percentage points by 2011, as recession pushes up public borrowing (see chart 4). If it does, Britain would end up somewhere in the middle of the pack. But the rapid rise in indebtedness is creating another vulnerability: markets need to feel sure that the government will make fiscal amends when recovery has set in, rather than seeking to inflate away the debt.

So far investors seem to be giving the Treasury the benefit of the doubt. Long-term borrowing costs remain low despite the mountain of new debt that will be issued over the next few years. That is vital; if gilt yields were to rise sharply it could lead to a vicious circle of rising debt-servicing costs and higher debt. Mr Darling laid out plans for higher taxes after the recession in his pre-budget report in November. In his spring budget he will need to reinforce his commitment to retrenchment.

Painful measures to restore health to the public finances will be all the more important because Britain's longer-term prospects have dimmed too. The economy's potential growth will be lower than before, and with it growth in the tax base. There are two main reasons, argues Martin Weale, director of the National Institute of Economic and Social Research (NIESR), a think-tank. The first is that the economy's expansion for most of the past decade was boosted by the apparent success of the financial-services industry. As that model turns out to have been unsustainable, the resulting retrenchment in finance will curb overall growth. The second reason is that falling investment means companies will have less capital to enhance productivity. Recovery in investment is likely to be muted because firms will face higher long-term borrowing costs, as banks and investors charge more for the risk of lending to them.



Despite this setback, the NIESR forecasts growth of 2.2% in 2011 and 2.4% in 2012, not least thanks to the greater competitiveness a lower pound will bring. The City may take a back seat this time. But Britain remains a diversified economy, and it retains a flexible labour market that will allow companies to adapt to new conditions, notes Trevor Cullinan of Standard & Poor's, a credit-rating agency that reaffirmed Britain's AAA status as a sovereign borrower earlier this year.

Illustration by David Simonds

Swindon had to cope with the collapse of the local railway industry in the 1980s, points out Bill Cotton, its director of economic development—one reason why he thinks the town can come through its latest trial. Tough times lie ahead, debt will have to be repaid and growth will be slower.

But just as there was too much optimism during the good times, so there can be too much pessimism in the bad times. RWE npower, an energy firm based in Swindon, for example, says it is going to boost its investment in Britain. Provided sound policies are pursued, above all credible plans to restore the public finances once a sustainable recovery has started, there is a way out of the mess. And, given the vigour with which monetary and fiscal policy has been eased, that recovery might just come sooner to Britain than to countries that look more resilient now.

Bankers at bay

Open season

Feb 12th 2009
From The Economist print edition

Bashing bankers is the latest sport

LIKE driven game, four once-proud chieftains of the Royal Bank of Scotland (RBS) and Halifax Bank of Scotland (HBOS) braved the massed guns of a parliamentary committee on February 10th. Since October, when both banks faced imminent collapse, the government has owned 58% of RBS (which may soon rise to 70%); in January HBOS was folded into Lloyds Banking Group (LBG), now 43% government-owned. In the first salvo, each ex-banker was forced to apologise for his role in the loss of billions of pounds on dodgy mortgages and aggressive expansion.

As they squirmed through accounts of why they had messed things up, and to a man blamed market dysfunction unforeseen by everyone, one exasperated committee member exclaimed: “You’re all in bloody denial!” Sir Tom McKillop, former chairman of RBS, was big enough to admit that buying a chunk of ABN AMRO, a Dutch bank, at the top of the market in October 2007, had been a “bad mistake”. But, he quickly added, the deal had been approved by all of RBS’s board members and 94.9% of its shareholders.

Embarrassment was also heaped on the HBOS pair by written testimony from the bank’s former head of risk. Paul Moore said that his warnings between 2002 and 2004 of an imbalance between a zealous sales culture and proper risk controls had led to his dismissal. According to Lord Stevenson, former chairman of HBOS, an independent inquiry showed this claim to be false. But the new focus on the past resonated outside the committee room: the following day Sir James Crosby resigned as vice-chairman of the Financial Services Authority (FSA). He was HBOS’s chief executive at the time of the Moore saga.

On February 11th the committee grilled current senior executives of the five biggest British banks—and were told of the many obstacles to changing the banks’ “casino” culture. Eric Daniels of LBG said his bank was contractually obliged to pay bonuses to employees of the former HBOS. Stephen Hester of RBS had similar obligations to employees of the former ABN AMRO. Mr Daniels met with incredulity when he insisted the Lloyds/HBOS merger was a good deal for his shareholders, despite the combined group’s need for a £17 billion bail-out. John Varley of Barclays, whose bank has made profits and spurned government capital, acknowledged the banks’ share of blame for seeking high returns from structured financial products.

These exercises in humiliation diverted attention from the committee’s—and the government’s—main task, which is to create a sounder banking system for the future. In a two-pronged attack the government is focusing on restraining remuneration and designing a new regulatory framework. In the short term it is attempting moral suasion to limit to £25,000 the cash element of bonuses at banks in which it has a large shareholding. For the longer term the Treasury has appointed Sir David Walker, a former banker and central banker, to review governance and pay. His remit is to find ways to align bankers’ incentives more closely with their employers’ and shareholders’ long-term fortunes, and to look at the role of independent directors. Directors with banking experience may be useful in devising solutions—but may also be complacent about bank practices. On February 10th one committee member suggested appointing some full-time, paid independent directors (not bankers) to “make things difficult” for management.

The rethink is part of a bigger review of bank regulation. The repercussions in Britain of the collapse of Lehman Brothers, an American investment bank, and of various now-bust Icelandic banks that operated in Britain, have shown the weakness of relying on home-country supervisors: those institutions’ national interests led them to pull their assets from Britain, though their British obligations remained. At the risk of damaging London as a world financial centre, the FSA has questioned the present licence for banks to “passport” across European borders. We need “either less Europe or more Europe”, said Lord Turner, the FSA’s chairman, on February 10th. Against this background, making a few bankers squirm is a minor sport.

Shipbreaking

Breaking up is hard to do

Feb 12th 2009
From The Economist print edition

A plan to dismantle old ships on Teesside continues to spark controversy

HARTLEPOOL, a mid-sized industrial town a few miles south of Newcastle on the North Sea coast, has a proud history of shipbuilding. During the second world war its yards were among the country's most productive, but later it suffered mightily as business fled Britain for cheaper yards overseas. When Grays, Hartlepool's most famous yard, closed in 1962, the town's unemployment rate jumped from 6.2% to 10% overnight.

AFP

A gift from the sea

Yet even today, its shipping industry is not quite dead. On February 8th the *Clemenceau*, a superannuated French aircraft-carrier, entered the town's giant Graythorp dock, where it was moored alongside four American warships. They are all to be broken up for scrap. Breaking ships takes less labour than building them, but Able UK, the firm carrying out the work, reckons the work will still create 170 jobs and boost Hartlepool's economy.

The celebrations have not been universal. Both the *Clemenceau* and her American berth-mates are old, and thus contain nasty chemicals, including mercury, lead, asbestos (a fireproof mineral widely used before its toxic properties became known) and polychlorinated biphenyls (poisonous chemicals used in electronics until their banning in the 1970s).

That environmental risk explains why the *Clemenceau* has come to Britain. She was decommissioned in 1997, and the search for a final resting place has been tortuous. Turned away by Spain and Turkey, the ship was slated to be broken up in India, which has a cheap, slapdash and thriving shipbreaking industry. She duly set sail for Gujarat in 2005. But amid protests from environmental groups, which argued that India lacked the equipment needed to dispose safely of all the chemical nasties, India's supreme court ruled that she could not dock. After a French court reached a similar decision, the *Clemenceau* returned to France. Able UK eventually won the contract, says Peter Stephenson, its chief executive, precisely because of its ability to dispose of the ship properly.

Everyone agrees that safe scrapping is a good idea, but some doubt that Able UK is up to the job. A local group called Friends of Hartlepool accuses the firm of spreading misleading propaganda, and argues that the Graythorp dock is unsuitable for dealing with dangerous chemicals because spillages could leach through the floor and contaminate the soil. They point out that Able UK was fined £22,000 in 2007 for a "reckless" breach of asbestos-dumping regulations at a nearby landfill site, and say that it has little experience of scrapping ships (the firm has broken up old oil rigs, which it says are similar). It has only been allowed to begin work after years of legal disputes. But greens are split: Greenpeace, a big environmental pressure group which opposed sending the *Clemenceau* to India, supports scrapping the ship in Hartlepool instead. Friends of the Earth, another green group, takes a similar line (although disaffected ex-members have come together in Friends of Hartlepool).

If the environmental aspects of shipbreaking are tricky, so are the economic. Rich-country companies

struggle to match the prices of firms in poorer places. Their selling point is environmentally conscious disposal. But many shipping firms are not bothered by such niceties, says Nicky Gregson, a geographer at Sheffield University. That could restrict the market for high-quality disposal to ships that are owned by governments, which tend to be more susceptible to eco-lobbying than private firms. The British government committed itself in 2007 to scrapping its ships properly and is encouraging the development of a British shipbreaking industry.

The vagaries of the market can be trying too. No sooner had the legal proceedings regarding the *Clemenceau* ended than the global financial crisis began. Commodity prices have tumbled, and the steel in old ships is worth much less than it was. “The value of our steel in stock has fallen by £29m in past six months,” sighs Mr Stephenson. Rather like shipbuilding half a century ago, he says, shipbreaking is a boom-and-bust business.

Grammar schools

Who goes where?

Feb 12th 2009 | BELFAST
From The Economist print edition

Goodbye to Northern Ireland's official 11-plus, hello to a privatised muddle

ONLY 15,000 results-bearing letters landed on Northern Irish doormats on February 7th. But the province's final run of the "11-plus" entrance exam for its grammar schools has assumed an importance beyond the children whose educational fate it decided. The test survived the 1970s, as a Labour government pressed English and Welsh schools to go comprehensive. Then arm-wrestling between nationalist and unionist politicians consigned the official exam to history—and left no agreement as to what should replace it.

Back in 2002 Sinn Fein, the largest nationalist party and in charge of the province's schools, declared the abolition of the 11-plus. Three days later Northern Ireland was once again under direct rule from London. Whitehall did nothing to reverse that decision, despite the opposition of unionist politicians. But during the 2006 negotiations that restored power-sharing, the largest unionist party, the Democratic Unionists, secured a promise that no future minister could impose a non-selective system without cross-community consent.

That consent has not emerged. One reason is electoral ambivalence: opinion polls show support for academic selection in principle, but a dislike of all practical ways of implementing it (including the 11-plus). Neither side has won the intellectual argument. Supporters of the 11-plus point to higher numbers achieving top GCSE and A-level grades in Northern Ireland than in mainland Britain, less socially exclusive universities and an almost complete absence of private schools. Opponents cite the higher numbers leaving school without qualifications and the fact that few poor children pass the 11-plus. Most importantly, to unionists grammar schools represent continuity and social conservatism, and are pretty much untouchable.

On February 2nd, after much delay and brinkmanship, the education department finally admitted that it had killed off the state 11-plus exam but was unable to come up with a replacement. Implicitly accepting that grammar schools may set their own entrance tests, it published guidelines for all schools: preferential treatment for locals and siblings of existing pupils, 20% of places to be reserved for poor children, and so forth. They will be widely ignored. Most of Northern Ireland's 69 grammar schools have said they will administer other, unregulated entrance tests—including at least eight Catholic grammars, despite the opposition of their church's hierarchy to academic selection.

To get a glimpse of the muddle likely to ensue, the province's politicians and parents need only look across the Irish Sea. In England, 164 grammar schools survived the 1970s cull and still use the 11-plus for admissions. Both Labour and the Conservatives oppose academic selection but are unwilling to provoke middle-class ire by rooting out its remnants. These living fossils are wildly popular (last autumn one Surrey grammar school had to call the police for crowd control when 1,500 children turned up to sit its entrance exam—for 126 places), but their freedom is being eroded.

Earlier this month two grammar schools in Dorset announced that from 2010 they would admit state-school applicants in preference to private-school ones, even if the latter had better 11-plus results. The change, they said, had been forced on them by the Office of the Schools Adjudicator, set up in 1998 to police admissions. And last year the watchdog told three Warwickshire grammars to stop admitting high-fliers from outside the county, on the grounds that they were undermining other areas' comprehensives.

When Labour came to power in 1997 it proclaimed its determination to make every school a good school. That optimism has given way to a sadder, meaner goal of preventing the middle classes from monopolising the good schools that already exist. The rules governing admissions have been made mandatory—and bewilderingly complex (yes to selecting 10% of pupils according to "aptitude" but not "ability", and only for "specialist schools"; yes to "fair banding", which classes children by ability and admits a representative sample, but no to the 11-plus—unless you are one of the 164 grammars; yes to religious schools demanding baptismal certificates and the like, but no to interviewing to ascertain

devoutness; and so on for 82 pages). Are Northern Ireland’s politicians really sure where their path leads?

Bagehot

The bloodhound versus the pimpernel

Feb 12th 2009
From The Economist print edition

Ken Clarke, Peter Mandelson and the weight of political history

Illustration by Steve O'Brien

LIKE rival champions before the walls of Troy, they keep offering to do battle, but somehow, so far, they haven't. Peter Mandelson, the business secretary, sits in the House of Lords, and Ken Clarke, his new Tory shadow, in the Commons; and there seems to be a wariness, on someone's part, to engage in the neutral territory of a television studio. Nevertheless, the contest between them has already been revealing. Both have been sucked back into front-line politics by the economic slump, but their resurrections imply very different things about their parties—in particular, about the pull and spell of those parties' histories.

In a sense Mr Clarke is living history. He has held most of the great offices of state, and knows the byways and absurdities of government. He understands that voters cannot be asked to bear too much painful reality, at least before polling day. As chancellor of the exchequer from 1993 to 1997, he steered the British economy out of its last recession.

And he is one of the few to have emerged from the wreck of that administration with his reputation intact. He is also one of the few widely recognisable top Tories, and of even fewer who are widely liked. He has been a Member of Parliament for longer than George Osborne, the shadow chancellor, has been alive; but he has cleverly cultivated an image as a sort of anti-politician. He is not a toff. All that makes him a comforting political presence for most Britons over 35. Routinely described as a "big beast" of Conservatism, he resembles a bloodhound more than a lion or bear: slightly shambolic and improbable, but dogged and effective.

Still, drafting in Mr Clarke represents a gamble by David Cameron, the Tory leader—about the party's past as much as about Mr Clarke himself. As a backbencher, Mr Clarke has been one of the most rebellious Tory MPs. He has now vowed not to push the pro-European views that stopped him becoming leader (with delicious ambivalence, he describes the current party line on Europe as "reasonably moderate"); but Mr Cameron must know that Mr Clarke will make the odd slip. The wager is that when he does, it won't matter: that the country, the media and most of all the party won't be too bothered. It is a bet, in other words, that the era of vicious splits and Euro-obsession is over; that the party is at peace, and no longer defined by its rows. Mr Clarke is Tory history incarnate. But his return also embodies its burial.

Lord Mandelson, meanwhile, is also a risky figure, and not only because he has been forced out of the cabinet twice. Like Mr Clarke, he lacks the long-term ambitions that make politicians trim and tow lines. He too has differed with his leader, though his dispute with Gordon Brown was more poisonously personal

than ideological. He too represents a gamble about the past—in a way, the opposite bet to Mr Cameron's.

With his conspicuous experience and sonorous gusto in interviews, Mr Clarke is a top-notch front-of-house politician. Lord Mandelson, by contrast, is the ultimate behind-the-scenes operator. That is not to deny that he is a decisive minister or a good media performer: as suave as Mr Clarke is rumpled, he is a lucid interviewee, alternately languid and icy. But the influence he wields in private—and is thought to wield—is more important.

Lord Mandelson exerts a sort of voodoo charm over the Tories: they see his secret influence, like that of the Scarlet Pimpernel, in anything cunning the government does. They detect it especially, and with justification, in the New-Labour-ish aspects of the government's crisis-management. The emphases on saving jobs by raising productivity, on promoting high-tech industry and rejecting protectionism, reflect a respect for markets, and a notion of government as active but limited, that were reinforced during Lord Mandelson's turn as a European commissioner.

This approach irks those Labour MPs who regard the crisis as a chance to unleash a big-state form of social democracy. A plan to part-privatise the Royal Mail, which Lord Mandelson has advanced, has enraged lots of those MPs. But that sort of strife once served New Labour well—by reassuring the middle classes that the party was not swinging left. And, at least around the cabinet table, Lord Mandelson has managed to sow relative harmony between Blairites and Brownites. (The categories remain valid, however, and views on Lord Mandelson are a good indicator of them. The Blairites say the business secretary is, in effect, the deputy prime minister. Others prefer to downplay his stature.)

His function, in other words, is to recapture the magic that brought Labour to power: the discipline and devout pragmatism that created a broad, landslide-winning coalition of voters. If the Tories are striving to transcend their history, Lord Mandelson personifies a hope that Labour can bring its past back to life.

The past is prologue

He is trying. During the recent wildcat strikes over the use of foreign labour, Lord Mandelson was robust in his defence of the European single market. He has been studiously reasonable in the row over bankers and their bonuses (though less successful, so far, in reinvigorating reform of the public services). All the same, judging from the opinion polls, it isn't enough. Disillusion with the government seems to be too strong. The old doubts about the Tories, meanwhile, are drifting away. Everyone remembers Mr Clarke; but the splits, the sleaze and the rest are receding.

The odd thing is that, if and when they do encounter one another, Mr Clarke and Lord Mandelson may find themselves largely agreeing, much more than they do with many of their party colleagues. Mr Clarke is in essence a New Labourite, some would say; give or take the odd yacht, Lord Mandelson is a Notting Hill Tory, others would retort. They would agree about Europe, public-service reform and swathes of economic policy. But they are embarked on radically dissimilar political missions: Mr Clarke's party is escaping into the future; Lord Mandelson's is forlornly trying to turn back the clock.

Economist.com WORLD INTERNATIONAL

Sport

Is it recession-proof?

Feb 12th 2009
From The Economist print edition

AFP

Nothing can entirely escape the economic downturn. But leading sports come close

GLOOMY days, these, for English cricket. On February 7th the England Test (international) side was skittled out for 51 runs, its third-lowest total in 132 years and 880 matches, as it slid to ignominious defeat against the West Indies, one of the lowest-ranked Test sides in the world.

England may be useless, but they're not worthless. The previous day, some of the players were auctioned—that's right, by a man with a gavel—for the second season of the Indian Premier League (IPL), a six-week tournament of short matches (lasting around three-and-a-half hours each) which begins in April. The services of England's two great crowd-pleasers, Andrew Flintoff and Kevin Pietersen (pictured above), fetched $1.55m apiece. A third member of the team scooped $275,000. For cricketers, these are huge sums—and the top price has gone up since last year.

There is little hint of global recession there. You might conclude the same from other sports, even in shrinking economies. The average price of television-advertising slots during this month's Super Bowl, American football's ultimate prize, was even higher than in 2008. And on February 6th the Premier League, the top tier of English football, said it had sold domestic live broadcasting rights for three seasons from August 2010 for nearly £1.8 billion ($2.6 billion), 5% more than the existing deal. Deloitte, a consulting firm, paints a broadly positive picture of European football in a report this week (see article).

Sport is not immune to economic woe. As Deloitte notes, the shirts of Premier League teams offer a brief history of the credit crunch: Newcastle United's sponsor is Northern Rock, a nationalised bank; Manchester United sport the initials of American International Group, an insurance company now owned by the American government; and West Ham went logoless for three months after XL, a travel company, went bust. On February 4th the Detroit Pistons, an American basketball team, failed to sell out a home game for the first time in five seasons. And although NBC, the Super Bowl's broadcaster, increased average advertising revenues, says Jason Maltby of Mindshare, a marketing and media consultancy, it struggled with the last few slots.

Yet leading sports are, by and large, standing up to recession better than most. They have two big advantages. It helps, first, to be able to sell broadcasters and sponsors what they crave in a world of myriad channels: lots of dedicated viewers. This advantage may even rise in a downturn. As recession grips, fans may decide that season tickets are too great a luxury, but they will cling on to their television subscriptions.

The other advantage is timing, which is just as important in the business of sport as it is on the field of play. Long-term broadcasting contracts help to lay a good base of revenue and some sports are in the

early days of such deals. The IPL, for instance, started out with a ten-year, $1 billion agreement. In America the National Basketball Association is in the first season of eight-year contracts worth $7.5 billion.

With a sought-after event, it is possible to plan ahead—beyond, with luck, today's troubles. The International Olympic Committee is already negotiating for the 2014 winter and 2016 summer games. So far it has struck separate deals for Italy and Turkey, rather than sell all European rights to the European Broadcasting Union as in the past, and has done rather better from them.

Not all sporting activities can rise above today's troubles. Away from the top table of sport, times look harder. Stefan Szymanski, an economist at Cass Business School in London, notes that sport is like any other industry: "All recessions are about consolidation," he says. The IPL is "pretty much recession-proof"; English county cricket looks much less robust. Of course there are winners and losers.

Even at the top, not all is rosy. Mr Maltby detects "cracks" in sponsorship as well as advertising. For example, cars in the National Association for Stock Car Auto Racing, or NASCAR, are no longer festooned with logos over every square inch. Some NASCAR teams have merged and selling the right to be a sport's official beer, say, may get harder.

This is not a good time to be looking for a sponsor to name a new stadium or for a lender to finance it. But the world of sport can console itself. In hard times people need escapism more than ever, it seems. They like heroes to watch and cheer. And still they are willing to pay.

Juries

The jury is out

Feb 12th 2009
From The Economist print edition

European countries are restricting jury trials; Asian ones expanding them

MARK TWAIN regarded trial by jury as "the most ingenious and infallible agency for defeating justice that human wisdom could contrive". He would presumably approve of what is happening in Russia and Britain. At the end of 2008, Russia abolished jury trials for terrorism and treason. Britain, the supposed mother of trial by jury, is seeking to scrap them for serious fraud and to ban juries from some inquests. Yet China, South Korea and Japan are moving in the opposite direction, introducing or extending trial by jury in a bid to increase the impartiality and independence of their legal systems. Perhaps what a British law lord, the late Lord Devlin, called "the lamp that shows that freedom lives" burns brighter in Asia these days.

It is often thought that juries are a peculiarity of common-law countries such as America and Britain. Not so. Twelve-member citizens' juries are widely used in Islamic-law countries, too. Even in civil-law ones in continental Europe lay jurors sitting alongside professional judges help reach verdicts in serious criminal cases.

Where the jury system is entrenched, it may not be common. In America, where a right to trial by jury is in the constitution, the vast majority of cases result in plea-bargains (so do not go to trial) or concern minor offences, which are normally dealt with by a single judge. In Britain, only 1% of criminal cases end up before juries, which rarely deal with inquests, either.

Britain is seeking to restrict juries even further. In 2003 the government gave itself the power to abolish juries in long and complex fraud trials, arguing that judges sitting alone or accompanied by expert "assessors" would be able to reach speedier, safer and cheaper verdicts. Such was the outcry that it agreed to seek fresh parliamentary approval before using that power. Five years and three bills later, it still hasn't succeeded. But plans to remove juries from coroners' courts when the public interest is involved (first proposed in a counter-terrorism bill but defeated) have resurfaced in another bill that is grinding its way through Parliament.

Russia's bid to do away with most jury trials has little to do with efficiency. Russia reintroduced jury trials in 1993 for several charges including terrorism, hostage-taking and armed insurrection to show its commitment to the rule of law. The commitment did not last. Research showing that Russian juries are nine times more likely to acquit defendants than judges sitting alone led to a decision to revert to non-jury trials for all cases save murder.

Meanwhile, three Asian countries are going the other way. Under a law that came into force in 2005, some 50,000 "people's assessors" have been appointed in China to serve in trials for all but the most minor criminal offences. Selected on merit and appointed for five years, Chinese assessors resemble English lay magistrates, likewise appointed for several years, rather than common-law jurors, who are usually chosen at random and serve for just one trial. Still, like jurors in civil-law countries, the assessors, sitting alongside judges, are required to reach decisions on law and fact, and sometimes help with sentencing, too.

In Japan, jury trials were once available in theory but little used in practice. Starting in May, though, six lay jurors, chosen at random from among voters, will sit alongside three judges in contested cases punishable by death or life imprisonment.

South Korea has been more tentative. In a bid to modernise an opaque legal system, it introduced juries in 2008, restricted to trials for the most serious crimes. At the moment, they are advisory. Under the constitution, all defendants must be tried by a judge, so giving juries decision-making powers would require a constitutional amendment. As elsewhere, the system has led to more acquittals. It is due to be reviewed by the Supreme Court in 2012.

Anti-poverty programmes

Quid pro quo

Feb 12th 2009
From The Economist print edition

Doling out cash with strings attached is a good idea, but no panacea

AMERICAN policymakers rarely take their cues from Mexico: advice usually flows the other way. So it must have been gratifying for those running Oportunidades, a welfare programme serving 5m poor Mexican families, when the city of New York turned to them in 2006 for help with Opportunity NYC, a new social-welfare programme promoted by the city's mayor, Michael Bloomberg.

Oportunidades is one of the best-known examples of an increasingly popular kind of social assistance called conditional cash-transfer (CCT) programmes. Unlike traditional welfare schemes, which dole out money without demanding anything in return, CCTs will only pay out if the recipients ensure their children regularly attend school and health facilities or schools alone.

These programmes have swept across the developing world. In 1997 Mexico was one of only three countries to have a CCT programme. By 2008, as the World Bank documents in a new report, virtually every country in Latin America had one. So did Indonesia, Nigeria, Burkina Faso, the Philippines, Bangladesh, India, Turkey, Cambodia, Pakistan and Kenya. Some of these programmes are huge: Brazil's Bolsa Familia serves 11m families.

Part of their attraction stems from the fact that making transfers conditional makes them more palatable to the middle class whose taxes finance them. It also helps their credibility that most CCT programmes have rigorous evaluations built in (by their nature, they need to know whether recipients have kept their side of the bargain). Governments like them because they make recipients more likely to support the ruling party (though so, probably, do conventional transfers).

CCTs do an excellent job of getting money to the poor. Children covered by them get more schooling and use health facilities more often than they would otherwise have done. Some fears have proved unfounded: poor people have not responded to cash payments by cutting back on paid work. Unfortunately, there is little evidence that CCTs raise educational standards (as opposed to attendance); and while children may go to clinics more, that does not mean their nutrition or immunisation rates improve.

The programmes may not be to blame. The problem may lie with the dire quality of schools and clinics. A study led by Michael Kremer of Harvard University found that a quarter of Indian schoolteachers were absent on any given day. CCTs, for all their advantages, cannot do much about that.

Burgeoning bourgeoisie

Feb 12th 2009
From The Economist print edition

Financial Times

For the first time in history more than half the world is middle-class—thanks to rapid growth in emerging countries. John Parker (interviewed here) reports

THE crowd surges back and forth, hands above heads, mobile-phone cameras snapping one of Brazil's best-known samba bands. It could be almost anywhere in Latin America's largest city on a Saturday night. But this is Paraisopolis, one of São Paulo's notorious crime-infested *favelas* (slums). Casas Bahia, the country's largest retailer, is celebrating the opening there of its first ever store in a *favela* (pictured above). It is selling television sets and refrigerators in a place that, at first glance, has no running water or electricity.

Among the shacks, though, rise three-storey brick structures with satellite dishes on their tin roofs. In the new shop, Brazilians without bank accounts—plumbers, salesmen, maids—flock to buy on instalment credit. In a country with no credit histories, the system is cumbersome: the staff interview customers about their qualifications and get them to sign stacks of promissory notes, like post-dated cheques, before allowing them to take their purchases home. But it works, more or less. According to Maria, a cleaner, "Everything I have comes from Casas Bahia. Things are very expensive but the means of payment are better for people like us, without any money." This is the emerging markets' new middle class out shopping.

Eduardo Giannetti da Fonseca, one of Brazil's most distinguished economists, describes members of the middle class as "people who are not resigned to a life of poverty, who are prepared to make sacrifices to create a better life for themselves but who have not started with life's material problems solved because they have material assets to make their lives easy." That covers a broad range of ambitions, as two other examples will show.

Back in 1992 Lu Jian was a dissatisfied mid-level bureaucrat at China's department of transport and communications who became surplus to requirements. Taking advantage of government measures that encouraged such officials to go into business, he went off for a stint at China's first commodity-futures trading company. Soon afterwards he found himself designing the country's first ski resort, near the northern city of Harbin. Now, as chairman of the Nanshan Ski Village, in the desert hills near Beijing, he presides over the capital's main winter-sports recreation ground.

This season 3m Chinese will take up a sport that was unavailable in the country only 15 years ago. China has around 300 ski runs, including some in the subtropical south where skiing is done indoors. Even in

freezing Nanshan, snow is manufactured from wells deep underground. “When the Chinese first got rich,” says Mr Lu, “they wanted to go to Thailand and South Korea. Now they want to go skiing.” Every weekend the resort is packed with IT executives, bankers and media glitterati. This is the emerging markets’ new middle class at play.

In December 2008, a week after the terrorist attacks in Mumbai, thousands of young, English-speaking professionals gathered in Mumbai, New Delhi, Bangalore and Hyderabad. They were demanding a new security law and a ban on criminals holding parliamentary seats, as well as urging people to vote. India’s professional classes have long been considered indifferent to politics and less inclined to vote than the poor. Yet suddenly social-networking sites were full of memorials to the victims and proposals for further action: vote, don’t vote, withhold taxes, join a new party. “Those laid-back, lethargic, indolent middle classes—they’ve been galvanised,” says a former advertising executive.” This is the emerging markets’ middle class engaged in politics.

So much to do

“We expect a lot from the middle classes,” say Abhijit Banerjee and Esther Duflo, of the Poverty Action Laboratory at the Massachusetts Institute of Technology. Following the historical examples of Britain and America, they are expected to be the dominant force in establishing or consolidating democracy. As a group, they are meant to be the backbone of the market economy. And now the world looks to them to save it from depression. With the global economy facing the biggest slump since the 1930s, the World Bank says that “a new engine of private demand growth will be needed, and we see a likely candidate in the still largely untapped consumption potential of the rapidly expanding middle classes in the large emerging-market countries.”

This special report will assess these expectations. It will argue that many of them are broadly justified; that there is indeed something special about the contribution the middle classes make to economic development that goes beyond providing a market for Western consumer goods. The middle classes can, and sometimes do, play an important role in creating and sustaining democracy, though on their own they are not sufficient to create it, nor do they make it inevitable. On balance, the report is optimistic about the prospects of countries where the middle classes are growing. But they are not a homogeneous group, so their impact varies. A middle class that has grown largely to tend to the state will behave differently from one that is based on the private sector.

The one-third rule

But who, as a patrician British prime minister, Harold Macmillan, once loftily asked, are these middle classes? Their members are neither rich nor poor but somewhere in-between. In countries long divided between lord and peasant, that has large consequences. “Middle-class” describes an income category but also a set of attitudes. In the words of Shashi Tharoor, an Indian commentator, it is a category “more sociological than logical”.

An essential characteristic is the possession of a reasonable amount of discretionary income. Middle-class people do not live from hand to mouth, job to job, season to season, as the poor do. Diana Farrell, who is now a member of America’s National Economic Council but until recently worked for McKinsey, a consultancy that has spent a lot of time studying the middle classes, reckons they begin at roughly the point where people have a third of their income left for discretionary spending after providing for basic food and shelter. This allows them not just to buy things like fridges or cars but to improve their health care or plan for their children’s education.

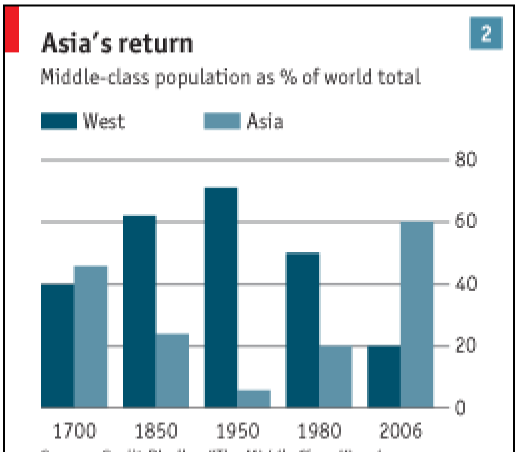
Usually, an income of that size requires regular, formal employment, with a salary and some benefits, that is, a steady job—another key middle-class characteristic. The income needed to have a third of it left over after meeting basic needs also varies from place to place. In China, for example, $3,000 a year may be enough in Chongqing or Chengdu, big cities in the west, but not in Beijing or Shanghai. So defining the middle class in absolute terms is hard (see article).

In practice, emerging markets may be said to have two middle classes. One consists of those who are middle class by any standard—ie, with an income between the average Brazilian and Italian. This group has the makings of a global class whose members have as much in common with each other as with the poor in their own countries. It is growing fast, but still makes up only a tenth of the developing world. You could call it the global middle class.

The other, more numerous, group consists of those who are middle-class by the standards of the developing world but not the rich one. Some time in the past year or two, for the first time in history, they became a majority of the developing world's population: their share of the total rose from one-third in 1990 to 49% in 2005. Call it the developing middle class.

Using a somewhat different definition—those earning $10-100 a day, including in rich countries—an Indian economist, Surjit Bhalla, also found that the middle class's share of the whole world's population rose from one-third to over half (57%) between 1990 and 2006. He argues that this is the third middle-class surge since 1800. The first occurred in the 19th century with the creation of the first mass middle class in western Europe (see chart 1). The second, mainly in Western countries, occurred during the baby boom (1950-1980). The current, third one is happening almost entirely in emerging countries. According to Mr Bhalla's calculations, the number of middle-class people in Asia has overtaken the number in the West for the first time since 1700 (see chart 2).

In many emerging markets the middle class does not grow incrementally, in line with, say, economic growth. It surges. Chart 3 below shows why. The vertical line represents an income of $10 a day, which is where Mr Bhalla considers the middle class to start. In 1980 there was hardly anyone beyond that line. The lop-sided bell shape represents the distribution of income in a country (in this case, China) with a tail of poor people on the left, a longer tail of rich ones on the right and a bulge of people on average incomes in the middle.



Source: Surjit Bhalla, "The Middle Class Kingdoms of India and China" (forthcoming)

As the economy grows, the bell moves to the right and as it meets the threshold, a great whoosh of people cross into the middle class. In reality, growth may be even faster because the shape of the bell has been changing. According to new research by Martin Ravallion, the director of the World Bank's development research group, income distribution in developing countries started to shift between 1990 and 2005. The bulge in the middle of the range got bigger, making the bell taller, so the middle class is growing even faster.

At a certain stage it starts to boom. That stage was reached in China some time between 1990 and 2005, during which period the middle-class share of the population soared from 15% to 62%. It is just being reached in India now. In 2005, says the reputable National Council for Applied Economic Research, the middle-class share of the population was only about 5%. By 2015, it forecasts, it will have risen to 20%; by 2025, to over 40%.

Sweet spot

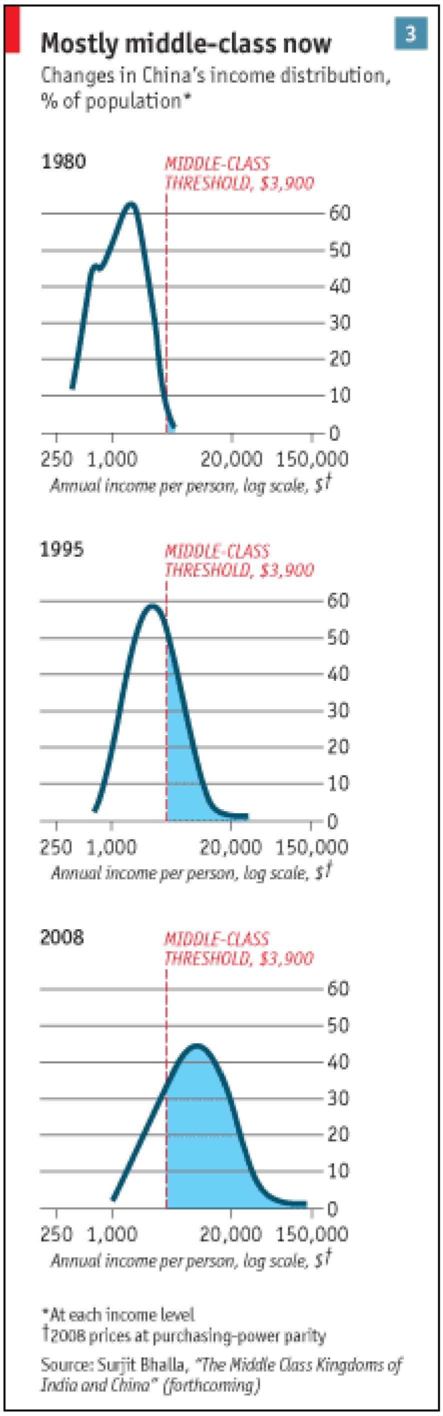
Homi Kharas, of the Brookings Institution, a think-tank in Washington, DC, argues that the point at which the poor start entering the middle class in their millions is the "sweet spot of growth". It is the moment when poor countries can get the maximum benefit from their cheap labour through international trade, before they price themselves out of world markets for cheap goods or are able to compete with rich countries in making high-value ones. It is also almost always a period of fast urbanisation, when formerly underemployed farmers abandon what Marx called "the idiocy of rural life" for the cities to work in manufacturing, boosting their productivity many times over. Eventually this results in a lessening of income inequalities because the new middle class sits somewhere between the rich elite and the rural poor.

The surge across the poverty line is a period of accelerating growth both for the new middle class and for the country it inhabits. That should continue for a couple of decades. By most estimates, the global middle class will more than double in number between now and 2030. This will have profound social consequences, as happened in previous middle-class surges.

Close to the creation of the world's first mass middle class in early 19th-century England, Thomas Malthus (the political economist who scared the world with his forecasts of overpopulation and food shortages) wrote that "it is probable that extreme poverty or too great riches may be alike unfavourable [to furthering the progress of mankind]. The middle regions of society seem to be best suited to intellectual improvement."

Marx, who admired Malthus, was equally astonished by the emergence of the middle class. As he wrote in the "Communist Manifesto":

> Historically it has played a most revolutionary part. The bourgeoisie, wherever it has got the upper hand, has put an end to all feudal, patriarchal, idyllic relations...It has accomplished wonders far surpassing Egyptian pyramids, Roman aqueducts and Gothic cathedrals...The bourgeoisie has through its exploitation of the world market given a cosmopolitan character to production and consumption in every country...All old-established national industries have been destroyed or are daily being destroyed. They are dislodged by new industries, whose introduction becomes a life-and-death question for all civilised nations...In place of the old wants, satisfied by the production of the country, we find new wants, requiring for their satisfaction the products of distant lands and climes...National one-sidedness and narrow-mindedness become more and more impossible, and from the numerous national and local literatures there arises a world literature. The bourgeoisie, by the rapid improvement of all instruments of production, by the immensely facilitated means of communication, draws all, even the most barbarian, nations into civilisation.



Who's in the middle?

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From The Economist print edition

It's a matter of definition

THERE are two main ways to define a middle class: in relative terms, as the middle income range of each country; or in absolute terms, using a fixed band for all countries. An influential exponent of the first approach was Lester Thurow of the MIT's Sloan School of Management, who took as his reference point the median income in America—where there is an equal number of people above and below the line—and defined the American middle class as the group with incomes lying between 75% and 125% of the median. Nancy Birdsall of the Centre for Global Development applied the same idea to developing countries. Bill Easterly of New York University selected those who were in the three middle quintiles of income (leaving out the poorest 20% and the richest 20%). The problem with this approach is that each country has a different median income, so the definition of what is middle class shifts from place to place.

An absolute definition avoids that problem. The question is what level to choose. In a paper in 2002, Branko Milanovic and Shlomo Yitzaki used the average incomes of Brazil and Italy as the respective floor and ceiling. That translates into roughly $12-50 a day per person, using household-survey data at 2000 purchasing-power parities (PPP).

On that definition, the middle-class population of emerging markets was about 250m in 2000 and 400m in 2005. The World Bank says it will be 1.2 billion by 2030. But despite that rapid growth, in 2005 this global middle class accounted for only 6% of the world's population and in 2030 it will still make up only 15%.

The main objection to this definition is that it excludes many people in China and India who are recognisably middle-class but earn less than $12 a day. India's National Council for Applied Economic Research found that between 1995 and 2005 the number of Indians earning $12-60 a day rose from 2% to only 5% of the country's population, but the number of those earning $6-12 a day rose from 18% to 41%.

An unpublished paper by Martin Ravallion at the World Bank uses a range of $2 to $13 at 2005 PPP prices. Two dollars a day is a commonly accepted definition of the poverty line in developing countries; people above this line are middle-class in the sense that they have moved out of poverty. Thirteen dollars a day is the poverty line in America, so this category might be described as people who are middle-class by developing-country standards but not by American ones. It is the developing world's own middle class.

Mr Ravallion's range captures the staggering growth of the emerging-market middle class. Between 1990 and 2005 the total almost doubled, from 1.4 billion to 2.6 billion, rising from one-third of the developing world's population to half. It also gives due weight to China, where the numbers living on $2-13 a day rose from 174m to a jaw-dropping 806m in just 15 years. In India the numbers rose from 147m to 264m, impressive in any other context. But Mr Ravallion's definition excludes people living on slightly above-average incomes in Brazil, who would generally be considered middle-class too.

Half the world 4

Population living on $2–13* a day, m

	1990	2005
East Asia and Pacific	315.5	1,117.1
of which China	*173.7*	*806.0*
Eastern Europe and Central Asia	355.3	347.8
Latin America and Caribbean	276.7	362.1
Middle East and North Africa	170.2	240.1
South Asia	192.7	380.2
of which India	*146.8*	*263.7*
Sub-Saharan Africa	117.7	197.1
Total	**1,428.1**	**2,644.3**

Source: Martin Ravallion

*2005 prices at purchasing-power parity

John Hewko of the Millennium Challenge Corporation, part of America's aid-giving system, points out that there is no single best definition; it all depends on what you want it for. If you need to know whether America's middle class is declining, for example, you use Mr Thurow's relative approach. To find out how many people in emerging markets might be, or become, customers for Western brands—the global middle class—you need something like the Milanovic-Yitzaki range: this is what McKinsey and Goldman Sachs use. And if you want to measure how many people in developing countries have moved out of poverty and into the middle class recently, the Ravallion/Banerjee-Duflo range is just the job.

Beyond Wisteria Lane

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From The Economist print edition

Scott Fitzgerald was wrong. It is not the rich who are different but the middle classes

IN 1943 Abraham Maslow, an American behavioural scientist, published an article entitled “A Theory of Human Motivation” in which he argued that people everywhere are subject to what he called a “hierarchy of needs”. At the bottom are food and shelter, sex and sleep: elementary physiological needs. Next come the basic needs for safety and security. As long as these things are lacking—as they are for billions of the world’s poor—the search for them dominates every aspect of life.

But once basic needs are met, people move up “Maslow’s pyramid” to look for other things: what he called “belonging needs” (love, acceptance, affiliation), “esteem needs” (self-respect, social status, the approval of others) and at the top “self-actualisation” (as he put it, “a musician must make music, an artist must paint, a poet must write if he is to be ultimately at peace with himself”).

Maslow was talking about individuals, but groups of people climb Maslow’s pyramid too, argues Brink Lindsey of the Cato Institute, a think-tank in Washington, DC. In America, says Mr Lindsey, material abundance has made people more self-absorbed, changing the character of culture and politics. This is what happens when people reach the top of the pyramid. Developing countries have yet to get there. Once they have solved the problems of food and security, suggests Mr Lindsey, the middle classes in those countries too start to turn to “belonging” and “esteem” needs.

Suburban revolution

Sociological research has confirmed that improvements in material circumstances change the behaviour and the thinking of whole groups. In 1967, within a generation of Maslow’s article, Herbert Gans wrote a classic book, “The Levittowners”, which described the changing mindset of America’s new middle class. Levittown was the original suburbia: a place of identical detached single-family houses with white picket fences. Lampooned for its uniformity (“Ant-like conformity now affordable”, joked a satirical newspaper, *The Onion*), it nevertheless influenced suburbs the world over.

In “The Levittowners”, Gans claimed that America’s new middle classes were thinking and acting very differently from the working-class communities in which most of them had grown up. Those traditional communities had been (to use terms popular at the time) “peer-group-directed”, taking their values and their outlook from people in their immediate circle, such as family and co-workers. By contrast, Gans argued, the middle classes were “other-directed”, taking their cues not only from family and friends but from managers in distant offices or from contemporaries they had heard about through other means, such as the mass media.

Peer-group people live by rigid codes set by their village or trade union. “Other-directed” folk are more flexible in their thinking. Mr Lindsey explains: “Middle-class life is built on abstract relations based on shared values…We are used to dealing with people we don’t know in order to get something done and do it by abstracting away from the particular details of our background or personality.” To use a famous metaphor, the mind of the peer-group-directed person is a gyroscope, pivoting on a single point; that of the other-directed person works like radar, taking in signals from near and far.

Research based on opinion polls documents the differences between middle-class and working-class attitudes. The best-known work of this kind is the World Values Survey run by Ronald Inglehart of the University of Michigan. It tracks attitudes to public institutions—such as the government or the church—and to broader social matters, such as the role of women or children. As countries get richer (and, by implication, more middle-class), the influence of traditional and religious authorities tends to fall away, though “Western” attitudes to personal and individual well-being are slower to develop. Just as people move up Maslow’s pyramid from “safety” to “esteem”, so countries rid themselves of some traditional attitudes without adopting individualistic Western notions about broader social *mores*. For this special report, *The Economist* asked the Pew Research Center to document the opinions of the global middle

class: the results, which confirm the distinctiveness of middle-class attitudes, are summarised in this article.

Mr Inglehart identifies three kinds of society. The first is dominated by traditional attitudes to authority and holds inherited religious and communal norms in great esteem. The next is “modern society”, which covers the majority of middle-income countries. The last is what he calls “post-modern society”, which values individual and subjective well-being above all else and downplays authority of any kind.

“Modern society” stresses the importance of economic growth and upward mobility. It is shifting away from traditional acceptance of established authority and putting more emphasis on law and rights. It engages in a wider debate of policy and politics. It is the kind of society in which people hope their children will do better than they have done themselves; which believes in merit, not privilege; competition, not inheritance; thrift, not conspicuous consumption; and which applauds personal effort rather than collective endeavour. It is a society summed up by the words of Margaret Thatcher, a former British prime minister: “We were taught to work jolly hard. We were taught self-reliance. We were taught to live within our income.” Lastly, it is a society whose critical characteristic, according to Justin Yifu Lin, the World Bank’s chief economist, is “aspiration, and the means to pursue it”. It is a society of the new middle classes.

The muddle classes

So far, this report has looked at what the new middle classes have in common, treating them as a homogeneous group. But, as Lawrence James says about the British variety in his book, “The Middle Class: A History”, they are “a sprawling, untidy organism in a perpetual state of evolution”.

Getty Images

Thatcher set the tone

For example, Kellee Tsai, a professor at Johns Hopkins University, argues that there is no such thing as a coherent middle class in China. Her research shows that two-fifths of Chinese private-sector entrepreneurs were born to farming families; one-fifth come from families of ordinary workers; and about 15% are children of government officials or enterprise managers. Their attitudes to China’s Communist party vary widely, from enthusiastic support to overt opposition, with the majority accepting the status quo. She also points out that private-sector entrepreneurship takes different forms in different regions of the country. So the term “middle class” covers a multitude of differences.

Pavan Varma, the director-general of the Indian Council for Cultural Relations, also thinks that in at least one respect the middle class of his own country behaves more like members of its elite than as a distinctive group of its own. Both, he says, have similar attitudes to the poor. Traditionally, the middle class has supported meritocracy and upward mobility, more than the elite has done. Yet, according to Mr Varma, the Indian middle class shows little inclination to fight the corruption, bad governance and incompetence that hold back the poor and block upward mobility through education. Unlike its peers in

other emerging countries, it has largely given up on public education, paying for private schools for its own children.

The most important division, however, is probably between the middle class created by the actions of the state and its equivalent created by its own efforts in the private sector. The first group contains managers and white-collar employees of state-owned enterprises, accountants and civil servants, and teachers and doctors in the public education and health systems. The second group covers private entrepreneurs, their employees and archetypal small shopkeepers.

To see how much these groups differ, consider economies in which oil plays a large part. Here the middle class is often puny or distorted. A 2003 survey by Tatyana Maleva of the Independent Institute for Social Policy in Moscow found that only just over 20% of Russians were middle-class by income or occupation. Depressingly, this was a smaller share than on the eve of the October revolution of 1917, when a quarter of the population was estimated to have been middle-class. In most countries with Russia's income levels the middle class accounts for half the population or more.

The distortions in the Gulf states are even more conspicuous. Kuwait has both a public-sector and a private-sector middle class, but they are totally separate. Over 95% of adult Kuwaitis work for the government, usually in white-collar civil-service jobs. The emirate also has a thriving private-sector middle class, but it consists almost entirely of foreigners.

Considered as a group of consumers, a middle class created by the state is unlikely to behave any differently from a private-sector middle class. Its members will buy the same branded goods, save up for the same houses, sign up for the same credit cards and aspire to put their children into the same schools. But there are question marks over whether the public-sector sort has the same entrepreneurial drive, political impact or capacity to sustain high economic growth over time.

Brazil offers a case study in the differences between a middle class created by the state and one that owes more to the private sector. In 2008 Brazil became a middle-class country by its own reckoning. In April of that year Brazilians with household incomes ranging from 1,064 reais to 4,561 reais a year, which is the middle of the country's income range, were found to make up nearly 52% of the population, up from 44% in 2002 and only one-third in 1993. Marcelo Neri of the Getulio Vargas Foundation, which carried out the research, says it shows Brazil has at last become a middle-class country after decades of effort.

The first big growth spurt took place in the 1960s behind high tariff walls. The middle class expanded fast thanks to jobs in state-owned companies, the public education system and the bloated civil service. "We grew the middle class faster than would have been possible with pure market forces," says Marcelo Giugale, the World Bank's chief economist for Latin America. "But it was the result of state policy, not growth." Income inequality also rose dramatically. By the 1980s Brazil had become the world's most unequal society.

Moreover, the economy was prone to slumps and episodes of hyperinflation. That made the middle class poorer (not least by destroying its savings) and caused it to rebel. "Our middle class was no longer willing to live in a closed society," says Mr Giugale. "People have become more outgoing and technologically savvy. They don't want their kids left behind by what the rest of the world knows. This is the middle class of satellite dishes and political activity. If you want to be middle-class now, you have to earn it; you can't have a state that creates a middle class as you could 40 years ago."

Panos

Where's the file with the entrepreneurial drive?

Private-sector growth and openness to trade has so far proved a more reliable engine of growth for the middle class than the old state-directed version. Between 2001 and mid-2008 Brazil experienced a long period of growth with low inflation, something it never managed in its earlier stop-start period.

By squeezing inflation out of the economy, argues Santiago Levy of the Inter-American Development Bank, Brazil has enabled people to expand their planning horizons and take out credit, which has soared. This has allowed a new middle class—a younger generation, mostly in their 30s and 40s—to start building up assets. By encouraging growth and improving the labour market, Brazil has greatly expanded the number of jobs in the formal economy (which matters because its informal sector is unusually large). Formal jobs, with health and pensions benefits, are a middle-class preserve. In the first quarter of 2008 Brazil's six largest cities created a record number of new jobs. Mr Neri talks of "the return of the *carteira de trabalho*" (the employment registration book that comes with a formal-sector job).

Moreover, thanks partly to a government cash-transfer scheme called Bolsa Familia, aimed at the poor, Brazil has reversed the vast rise in income inequality that accompanied the earlier period of state-led middle-class expansion. The Gini coefficient, a measure of income inequality, fell from 0.628 in 2003 to 0.584 in early 2008, which by the standards of this index amounted to a social revolution. Vinod Thomas, the World Bank's former country director in Brazil, reckons the lessening of income inequality has come in roughly equal measure from cash transfers to the poor, better education and jobs growth. Brazil's poorest provinces are growing faster than its richer ones, helping to narrow the gap between its rich and its poor regions (whereas the opposite is true in India and China).

The emergence of a new middle class in Brazil has gone hand in hand with an increase in political stability. If the next presidential election is held in 2010, as planned, it will be the fourth one in a row to be conducted under the same rules. The last time that happened was in the 19th century.

Brazil's economic record is not all jam. As Marcelo Carvalho of Morgan Stanley argues, the country owes more of its recent growth to the commodity boom than its policymakers realise, which suggests that it is more vulnerable to the downturn in raw-material prices than its leaders think. Even so, seen through the eyes of the middle class, recent times compare favourably with the period of economic take-off in the 1960s. In Brazil, the middle class is at last delivering on its long-standing promise of growth, stability and equality.

What do you think?

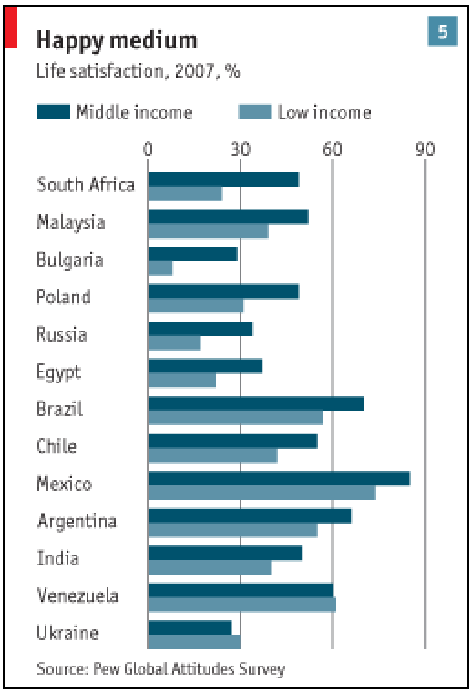
Feb 12th 2009
From The Economist print edition

A special poll on middle-class attitudes

ECONOMIC studies of the middle classes are plentiful, but opinion-poll research—especially involving international comparisons—is thin on the ground. So *The Economist* asked the Pew Research Center to trawl through its Global Attitudes database for this special report.

Pew looked at 13 middle-income countries in which the middle class is large or growing and classified their responses to questions about religion, democracy, life satisfaction, homosexuality and the environment by income. The threshold it used for “middle-classness” was a self-reported income of $4,286 a year in 2007 PPP dollars, consistent with the range of $4,000-17,000 a year used by the World Bank. Pew then compared these answers with the rest of the sample. Its middle-class group included the rich (defined as those with over $17,000 a year), but their numbers were not statistically significant. The survey therefore compares the attitudes of the global middle class with those of the poor in the same countries. Andrew Kohut, the Pew Research Center’s president, describes it as “the most comprehensive analysis of the ways in which the middle class in emerging markets differs in its attitudes to life and society”.

The differences can be large. In half of all responses there was a gap of five to 15 percentage points between the answers given by the middle class and by the poor. For example, 52% of middle-class Venezuelans but only 42% of poor ones say homosexuality should be accepted as a way of life. The middle-class differences run mostly in the same direction. The middle class is more likely to see competitive elections as important (by an average of 8 points); somewhat more concerned about global warming; and less religious than the poor (for full results, see pewglobal.org/middleclass).



The biggest differences are in so-called “life satisfaction”. Asked to rate their personal position on a ten-point scale of satisfaction, middle-class respondents are far more likely to put themselves near the top than are poor ones. The finding is consistent with polls showing that countries tend to become happier as they get richer. But the differences in current satisfaction are bigger than might have been expected (see chart 5). The middle class is also far more likely than the poor to expect a better life in future. These findings qualify the common view that economic growth unleashes myriad discontents.

The Pew survey also provides evidence to support two other arguments put forward in this special report. One is that the middle class varies a good deal from place to place. The gap in attitudes between the global middle class and the poor seems greater in most of eastern Europe and Spanish-speaking Latin America than in, say, Egypt, India and Brazil. The second is that the middle class supports democracy, which the poll bears out. Given widespread scepticism about this, it is perhaps the most striking finding of all.

Middle-income people are more likely than the poor to say they want competitive elections with at least two parties; more likely to demand fair treatment under the law; and more disposed to back freedom of speech and the press. However, their attitudes about politics do not differ quite as much from those of the poor as they do on religion, homosexuality or happiness. It is also true that these indicators are blunt instruments for describing often subtle attitudes.

Still, the findings are consistent across all questions and across all countries (even in Russia, where backing for democracy is low, half the middle class supports fair elections, compared with barely a third of the poor). The poll, concludes Mr Kohut, shows that “when they make it into the middle class, people in emerging markets want the kind of governance associated with rich nations.”

Notions of shopkeepers

Feb 12th 2009
From The Economist print edition

Why the new middle classes are so good for their countries' economies

MOST Western businessmen think the middle class in emerging markets matters because of its spending potential. One day those billions of Chinese, Indians and Brazilians will be buying awesome quantities of toothpaste or computers. A global consumer society will be born.

Walking around the stores of Sanlitun Village, a shopping mall in central Beijing, it is tempting to imagine that those dreams are already coming true. Young Chinese couples dressed to the nines ogle the latest computers and BMWs. The architecture looks like a collection of recent international design-award winners: the Apple store a cool glass box, the Adidas one a jagged shard of orange and ochre, all arranged around the obligatory skating rink.

It's magnificent, but it is not the typical middle-class shopping experience. A more representative specimen can be found in central India, a five-hour drive from Hyderabad, on the outskirts of Gulbarga in Karnataka state. This shop, described by Abhijit Banerjee and Esther Duflo, is a dimly lit corner of a family house. The goods are kept in plastic jars: one of snacks, three of sweets, two of chickpeas, 20 teabags, three packs of washing powder—22 products in all. The family also runs a scrap-metal business and earns between $2 and $4 a day. During a two-hour visit, two customers came by. One bought a box of incense, the other a single cigarette.

Yet between them the village shopkeepers and the yuppie shoppers are changing the economies of both their home countries and the globe. Surjit Bhalla reckons that the larger a country's middle class, the faster its economic growth: according to his calculations, a nation's growth rate rises by half a point every time the size of the middle class increases by ten percentage points (so if a country's middle class accounts for 50% of the population, it will, other things being equal, have a growth rate one percentage point higher than a country whose middle class makes up 30%).

Bill Easterly of New York University reaches similar conclusions, though he defines the middle class differently. "Countries with a middle-class consensus", he says, "have higher levels of income and growth…more human capital and infrastructure accumulation…better economic policies, more democracy, less political instability, a more 'modern' sectoral structure and more urbanisation." On his measurement, an increase of one standard deviation in the middle class's share of national income is associated with one extra percentage point of growth per person.

Why should the middle class encourage growth? The simplest explanation is that it doesn't. The middle class and growth go hand in hand because they are both results of something else: economic policies. In essence, the policies that made possible China's vast increase in wealth over the past 30 years were determined by just one man: Deng Xiaoping. There was no frustrated incipient middle class urging change in 1978. It was a similar story in India in 1991: the middle class grew bigger thanks to the willingness of Manmohan Singh, then the finance minister, to tear up the "Licence Raj". At first shrug, the expansion of the middle class seems to be a consequence of change elsewhere, not a cause of anything in its own right.

Avid consumers

Yet there is a handful of reasons for thinking that something special about the middle class itself—some intrinsic quality of middle-classness—contributes to growth, efficiency and the enrichment of a society. The most common argument is that the middle class matters because it does a lot of consuming.

The new bourgeoisie has created an enormous market, even if you ignore wild extrapolations about the future. In 2008 the number of cars sold in the big emerging markets exceeded that sold in America for the first time. In 2007 India had slightly more mobile-phone users than America and China had more than twice as many. Since 1994 business services in a range of emerging markets including India and

Brazil have grown by 250-700%; in Europe and America they have roughly doubled.

The newly affluent in emerging markets echo the tastes of the English middle class 150 years ago. They want travel, improved health services, private schools and better public infrastructure. Like the Victorians, they are also keen on self-improvement. On one (conservative) estimate, 30m Chinese children are learning to play the piano. “The discipline will be good,” says one proud mother. On a more frivolous note, Brazil is number one in the world for liposuctions, number two for plastic surgeries (after America) and number four for the number of gyms.

But as Diana Farrell points out, the really transformative thing about middle-class consumption is the signal it sends to producers. The demands of middle-class consumers in the developing world feed investment in new sorts of production, which raises income levels and changes the way business is conducted.

The best-known example is the Nano, the $2,500 car designed by India’s Tata Motors. Until it made its appearance, nobody in the automobile business believed that you could design a proper car that sold for less than about $5,000. By radically simplifying production and by stripping down the design, Tata’s engineers managed to cut that supposed floor price in half.

AFP

In the pink

There is no guarantee that the Nano will succeed. It has been plagued by well-publicised production problems. It may not satisfy its target market, being too cheap for the rich who can afford traditional small cars and too dear for the middle classes who currently ride motorbikes. But if it does take off, it could change car-buying habits around the world. At one-fifth of the price of a cheap family saloon in the West, some American or European families might decide to buy two or even three Nanos instead.

A similar story has emerged in banking. ICICI, an Indian bank, has cut the transaction costs of banking to far below those of its competitors by adding lots of new features to mobile-phone banking and cutting out layers of waste, says the bank’s Mr Vaidyanathan. Just five people manage the 250,000 daily transactions processed by ICICI Direct, its online share-trading arm. The cost of mobile-phone banking in India is roughly one-third of what it is in America. This has made it possible for ICICI to reach previously unbanked customers in India’s second- and third-tier cities, reaping further economies of scale. Last year it added 4m new customers.

Seen as a market, the new middle class in emerging countries is still relatively poor but very large, so it provides incentives to offer things that are cheap and can be sold in their millions. In terms of its total spending power, though, it still lags well behind its peers in the rich world; nor is that likely to change soon. According to a World Bank study in 2007, the rich (in this instance meaning everyone with an income per person above the average for Italy, wherever they live) accounted for 57.5% of total world income in 2000, a figure that is likely to rise to 69% by 2030 (because the ranks of the rich are swelling, too). The share of world income taken by the global middle class (on $13-50 a day), at 14%, will remain more or less flat between 2000 and 2030. So its role in consumption can be only part of the story.

Keen investors

To grasp the true economic significance of the global middle class, says Daron Acemoglu of the Massachusetts Institute of Technology (MIT), you have to look at the second main reason why it contributes to growth. It is more committed than the elite to a mixed, competitive economy.

For many rulers in poor and middle-income countries, political control is based on control of resources, especially land. The aristocrats of pre-industrial Europe were all landowners. Nowadays the same sort of political control is exercised in oil-rich economies through control of the oilfields and the distribution of oil wealth.

An elite that depends on land or raw materials, argues Mr Acemoglu, tends to be wary of new economic activities that might compete with its source of wealth and erode its political power. And since openness to foreign ideas is the single most important source of new technology and skills in developing countries, a reluctance to invest in new things is also likely to keep an economy more technologically backward, less skilled and more inward-looking. This can suit the elite perfectly well.

Consider Russia since the Kremlin elite expanded its influence over the oil sector under Vladimir Putin (who is now prime minister). The oil industry has lost foreign technical input, the country has become less open to the outside world and the influence of the middle class, already weak, has ebbed further. The Kremlin regards this as a success.

Unlike the Kremlin, the emerging-market middle class does not have a political monopoly to defend. Its members are therefore more willing to invest in businesses and technologies that might offer competition to the elite; they are also more likely to be open to the outside world. So middle-class growth, trade openness and new businesses tend to go together. That is in evidence in China, whose elite is not gorging itself on oil money. There, the cities of the eastern seaboard, especially in the Yangzi and Pearl river deltas, are the fastest-growing, most technologically advanced, most open and also most middle-class areas of the country.

Thanks to this middle-class predilection for investment, China has been able to tread a classic path towards increasing the value of its exports. Starting in the 1980s with labour-intensive activities like simple plastic assembly and mass-market textiles, it moved into more capital-intensive but low-margin electronics and consumer goods in the early 2000s and is now trying to move further up the chain into higher-value electronics and business services. A single town half-way between Shenzhen and Guangzhou, in an area which used to be all collective farms, started off making toys in township and village enterprises and by 2002 was producing 40% of the magnetic recording heads used in hard-disk drives throughout the world.

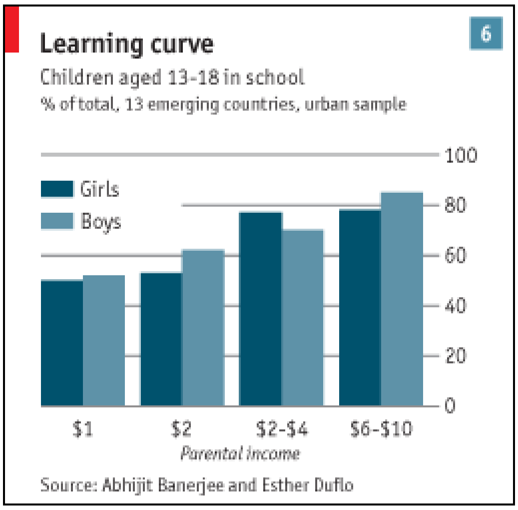
Something similar is happening in India, albeit in a more confusing manner. Whereas China exports a relatively narrow range of products, India exports all kinds of goods, ranging from those typically made by very poor countries to those produced by very rich ones, and everything in-between. It has huge capital-intensive businesses such as steel and shipbuilding, labour-intensive ones like making T-shirts and farming, and low-capital but high-skill ones such as information-technology services. The mix partly reflects the Indian middle class's willingness to invest in almost anything.

Creating human capital

But aptitude for investment is only part of what makes the middle class important to economic growth. Mr Banerjee of the MIT's Poverty Action Laboratory, who with Ms Duflo did an extensive analysis of the emerging world's middle class, lists three more characteristics that are just as vital.

First, the middle class is committed to education. Current theories about economic growth stress the importance of what economists call "human-capital accumulation". Human capital means more children at school and university, higher educational qualifications, more adult education and healthier lives. The more advanced the economy, the more educated people are needed to control the processes of wealth creation (more computer designers, more logistics technicians and more white-collar workers in general). The richer the country, the higher its human capital, and vice versa.

Education is high on any list of middle-class values. Around the world, parents scrimp and save to send their kids to school and compete with one another to get into the best schools. The middle class invests more in the next generation than do either the poor or, in one way, even the rich. Middle-class families do not take their children out of school to work in the fields or in a sweatshop because they do not need the tiny extra income a child's labour brings in. In several countries, school enrolment rates for children aged seven to 12 in families earning $6-10 a day are twice as high as in families on less than $2. Members of the middle class are also more likely to let their children stay on at school as teenagers, especially if they live in cities. Among the rural poor, fewer than half have children aged 13-18 in education, whereas among those living in cities and earning over $2 a day the figure is over three-quarters (see chart 6).



The rich in emerging markets certainly believe in educating their own children. But they often do not support universal public education, for fear that this will lead to demands for more democracy and challenges to their political dominance. The middle class in most countries strongly backs state schools.

As you would expect, middle-class families also spend proportionately more money than the poor on their children's education. Mr Banerjee and Ms Duflo sifted through household-spending accounts in 13 developing countries and found that in Nicaragua, for example, those on less than $1 a day spent 5.6% of their income on schooling; those on $2-4 a day spent 8.6%; and those on $6-10 about 9%. Mexico, Peru, Indonesia and Panama all showed a similar pattern.

Part of this extra money goes on keeping children at school for longer, but most is spent on private-school fees or on private tutors after school hours. Especially in India, private schools (many costing as little as 50 cents a day) are springing up everywhere. According to one study, two-fifths of all boys of secondary-school age in urban India are getting some after-school tutoring.

Moreover, these numbers understate how much middle-class people are spending per child. In emerging markets, Mr Banerjee and Ms Duflo found, middle-class families have fewer children than the poor. Among the very poorest (those scraping by on less than $1 a day), the number of children in the household ranged from 1.8 to 3.6 per adult woman. In families that live on $6-10 per person, the average number of children per household was between 1 and 1.3 (these figures do not include China so they are not influenced by that country's one-child policy). The middle class spends substantially more on each child.

The same sort of thing is happening in health care, another aspect of human capital: middle-class people lead healthier lives than the poor, go to the doctor more often and spend more per visit. If investing in human capital is the key to growth, then a large middle class will make that key easier to find.

Natural entrepreneurs

The middle class's third distinctive contribution to growth is its gift for entrepreneurship. "Armed with a capacity and a tolerance for delayed gratification," says Mr Banerjee, new entrepreneurs "emerge from the middle class and create employment and productivity growth for the rest of society."

The middle class is better at entrepreneurship than the elite partly for the reasons cited by Mr Acemoglu: it is more likely to invest in new businesses and more willing to learn new ways of doing things. But that is only part of a wider picture.

The middle class is more numerous and more heterogeneous than the rich, and therefore more likely to

produce both a mass of hard-working business people and a few exceptional entrepreneurs: people such as Nandan Nilekani, one of the founders of India's Infosys and *Forbes* magazine's Businessman of the Year for Asia in 2007; or Li Qinfu, a former Red Guard who built a miniature replica of America's Capitol in Shanghai as headquarters for his textile and manufacturing conglomerate—and put a three-tonne statue of himself on the top.

Most importantly, argues Mr Banerjee, the cream of the middle class is a better source of entrepreneurship than the poor because it can set up companies big enough to create lots of jobs. Profitable investments often incur substantial fixed costs. The dream of a couple of college kids with a few savings creating an Apple computer in a garage could come true only in a rich country, with a big financial sector and a low-cost distribution system. Emerging markets do not have those.

Businesses owned by the poor—and, indeed, by the poorer end of the middle class—remain resolutely small. Hardly any of the companies owned by people earning less than $10 a day surveyed by Mr Banerjee and Ms Duflo had more than three employees. Most were run by one person. To create companies that employ tens or hundreds of people, you need hundreds or thousands of dollars. If, say, a talented car mechanic in central India or north-west Brazil wanted to set up a string of garages, he might well need $10,000-worth of equipment. In the absence of a sophisticated banking system, his chances of borrowing that sort of money would be remote. So setting up new companies of any size usually requires resources available only to the rich—who may not be interested—or to the well-off middle class. Infosys was created by seven people from this sort of background. One was the son of a schoolteacher, another the son of a textile-mill manager. A third pawned his wife's jewels to help raise money. Infosys now employs 91,000 people.

The middle class's last distinctive contribution to growth comes through its support for the right economic policies and its backing for democracy. That is the subject of the next article.

Economist.com SPECIAL REPORTS

The other Moore's law

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From The Economist print edition

"No bourgeoisie, no democracy"; Barrington Moore may have had a point after all

In December 2008, 300 people in China risked arrest to sign and distribute a document called Charter 08. It demanded the abolition of Communist Party rule, free elections, a new constitution, separation of powers, an independent judiciary and freedom of expression, assembly and religion. Charter 08 was not a specifically middle-class manifesto. Its most notable—and, to the Communist government, alarming—feature was the wide range of those who had signed it: farmers, former party officials, dissidents from the Tiananmen Square era, a Tibetan blogger.

AFP

Divided by headscarves, and much else

But the signatories did include representatives of China's new middle class, especially lawyers active in the so-called "rights movement" who take up cases involving property law and environmental protection. The document calls for the protection of private property, a quintessentially middle-class concern everywhere. Although the official media stifled news of the charter, discussion of it quickly spread on the internet, the favourite medium of China's new middle class. Within a week 5,000 people had added their signatures.

The appearance of Charter 08 came against what might be called the run of play in politics in China and elsewhere in the developing world. The middle class used to be seen as the single most important force in democratisation. Even Malthus had argued that "if we could find out a mode of government by which the numbers in the extreme regions [ie, rich and poor] would be lessened and the numbers in the middle regions increased, it would be undoubtedly our duty to adopt it." In 1966 Barrington Moore, an American historian, pithily summarised decades of scholarly opinion in his formula, "no bourgeoisie, no democracy".

But that view has been changing. Moore's academic successors increasingly see the middle class as marginal to establishing a democracy. Some of them think that the poor are more influential, others that the main actors are particular individuals, not social groups. In much of the post-communist and developing worlds, the giddy hopes for liberal democracy that grew up after the Berlin Wall came down have given way to a period of disappointment and democratic stagnation. Despite the huge growth in the middle class, the number of elected democracies worldwide, as tracked by Freedom House, an American advocacy group, has been flat since the mid-1990s.

China's 800m-strong new middle class has conspicuously failed to rise up against its rulers. Russia's smaller, weaker middle class seems to have colluded in the reversal of hard-won but fragile freedoms: hence the popularity (across all classes) of Mr Putin. In both countries, middle-class fear of instability seems to have trumped democratic impulses. Their middle classes have also provided some particularly ugly manifestations of aggressive nationalism: for example, during the controversy over the Olympic torch for last year's Beijing Games, and in Russia's war on Georgia.

Middle classes in other emerging countries, faced with the disputes and strains of democratisation, seem more likely to deepen political divisions than to resolve them. That is what has happened in Thailand, where, after a year-long political impasse, the middle class split between the urban groups of Bangkok, many of which allied themselves with the royalist elite, and their peers in the smaller cities and the countryside, who linked up with farmers and with the political groupings of Thaksin Shinawatra, a former prime minister. This split has undermined democracy.

Something comparable can be seen in Turkey, where legal disputes over the wearing of headscarves in public buildings and over the legality of the ruling AK party have pitted the secular-minded middle class of Istanbul against the new, more devout middle class of Anatolia. In South Africa, the split within the ruling African National Congress can be linked to dissatisfaction with its performance by the "black diamonds", South Africans who have worked their way up into the middle class since the end of apartheid.

Worst of all, the middle class has sometimes contributed to the most brutal violence. Kenya is probably the most middle-class country in East Africa but that did not prevent it, in early 2008, from descending into horrendous tribal strife. Sri Lanka and the Indian state of Tamil Nadu are two places in South Asia where the middle class has thrived most. But the Tamil middle class has helped to finance a terrorist group, the Tamil Tigers, and now the Sinhalese middle class is cheering the no less brutal military offensive against the Tigers by the Sri Lankan armed forces.

In sum, the record suggests that a thriving middle class is not a sufficient condition for democracy. China has a middle class without a democracy. Nor is it a necessary one. India had a democracy before it developed a middle class.

Mutual infiltration

Yet that does not mean to say that the middle class has only a marginal role in creating or sustaining democracy. Its preferences are clear. As the Pew poll mentioned earlier in this special report found, the middle class consistently supports a competitive democracy and freedom of speech and the press. But its actual influence is often indirect, patchy and dependent upon other groups. This is true even in China, which is always cited as evidence that there is no link between democratisation and the existence of a middle class.

Over the past few years China has been swept by two broad social changes, both of which reflect middle-class influence. One is the "rights movement" in which China's new generation of private-sector lawyers is taking up cases of abuse of power, usually by local party officials, and challenging them in the courts. It has been especially active in environmental cases, where lawyers are fighting a rearguard action on behalf of communities affected by environmental degradation, and in property-law disputes, where the vast expansion of home-ownership has caused many conflicts between the new owners and property developers or the state.

The other social change has been the growth of the internet. Last year China overtook America as the country with the largest number of internet users. Most of them are middle-class. Guo Liang of the Chinese Academy of Social Sciences argues that the spread of the net is transforming what the middle class knows about the world and how its members interact with one another. Large majorities of users say the internet helps them understand politics better and influence political leaders more. And though the government censors and controls the net, he says, it can do so only at the margin.

Perhaps most importantly, the middle class has influenced the aims and make-up of the party itself. China's Communist Party used to be a strongly ideological institution dominated by farmers and industrial workers. Now most of the top party leaders are engineers and other professionals. It has set up a rigid career structure in which leaders are identified early and sent to show their mettle in minor regional posts before re-emerging at the top, like sons of factory owners learning the ropes before inheriting the business. The party is obsessed with qualifications: its leaders all seem to have postgraduate degrees, often from America. It is strongly corporate, hierarchical and career-oriented, resembling nothing so much as any great American corporation in the 1950s. This is mutual infiltration. The party keeps tabs on the middle class; the middle class influences the party. China's middle class has remade Mao's party in its own image.

So what is it about the middle class that influences politics? To oversimplify, its crucial feature is heterogeneity. Compared with the poor and the rich, the middle class contains a greater range of

interests. It covers a wide range of occupations: software engineers, shopkeepers, teachers and all the manifestations of economic complexity. On the widest definition, it covers everyone from the almost poor, on $2 a day, to the almost rich, on $100 a day. It includes people with barely a foothold on the economic system and those who are pillars of it.

Fifty-seven varieties

Because of this variety, the middle class is driven by a wider range of concerns than either the poor—whose main worry is the need for more money—or the elite, who concentrate on defending their political or economic position. The middle class is not a narrow special-interest group in the same way.

This heterogeneity is important. One test of that importance is what happens when it is absent, or thought to be absent. For example, the Turkish elite fears that the new "Muslim middle class" (the economically successful groups from Anatolia who support the AK) is not heterogeneous but merely acts as a single-minded Trojan horse for Islam. Hence the elite's extreme suspicion of those groups. Where the middle is not seen as heterogeneous, the politics of the country is often divisive.

But where variety is the rule (as it usually is), it has two main effects. First, says MIT's Daron Acemoglu, a heterogeneous middle class makes the elite less fearful of democracy than it would otherwise be. The elite fears democracy not just because it might mean giving up its position of power (which actually does not always follow) but also because of the potential effect on its wealth. Land is easy to tax, so a land-owning (or oil-controlling) elite will naturally worry that, if the poor gain greater political influence, they will use it to impose punitive land taxes or land reforms.

Oil-producing countries in which the elite controls the oilfields are hardly ever democracies. And in places where people have grabbed power claiming to represent the poor (Venezuela, Bolivia), the first result has often been swingeing taxes on land or raw materials. Mr Acemoglu argues that a thriving, varied middle class will be opposed to punitive taxes, too, so if the elite thinks the middle class will prevent drastic redistribution, it may be more willing to accept democracy.

A force for moderation

Other things being equal, any group in the middle should act as a moderating influence on social conflicts. By definition, a growing middle class will reduce income inequality because it will moderate the stark divide between rich elite and rural poor that is often a source of conflict in emerging markets. The middle class also tends to be inclusive. For example, non-governmental organisations backed by the middle class campaign for better treatment of indigenous peoples in Latin America.

In India, the middle class has eroded the caste system, especially in the south. Companies such as Infosys make a point of being caste-blind in recruitment. But Dipankar Gupta, a sociologist at Jawaharlal Nehru University in New Delhi, says that even though the importance of caste hierarchy may have declined, that of caste identity—the voluntary association of people of the same or similar castes—has increased, because as people leave their villages, caste often provides the only ready social network in the big cities.

In sum, the middle class acts as a buffer. Sometimes it allies itself with the poor, sometimes with the rich. That does not guarantee the emergence of democracy, but the presence of a large, varied middle class does make democracy more attractive than if a country is dominated by just two classes. As Aristotle said, "the best political community is one in which the middle class is in control and, if possible, outnumbers the other two classes."

Such a large, varied middle class encourages new policies, often (though not always) more liberal ones. To oversimplify again: the characteristic political demand of the poor is for transfers. They want a new well in the village or electricity for the slums. This encourages a politics of patronage. The characteristic political demand of the middle class is for things like property rights and a stable economic policy. This tends to give rise to a politics of accountability, if not necessarily democracy.

To see the difference, says Arvind Subramanian of the Peterson Institution for International Economics in Washington, DC, consider two examples from India. Mayawati, the chief minister of the country's largest state, Uttar Pradesh, has used her government to dispense patronage to the *dalits* (formerly called

untouchables, a poor caste). It has doled out favours to that particular group but done little to improve the lot of other poor people.

In contrast, Mr Subramanian argues, the middle class supports not only those things that specifically benefit its members—such as the Indian Institute of Technology system, the most successful part of public education—but also things that benefit the nation, notably the decision in 1991 to liberalise the economy. Because the middle class contains so many competing interests, patronage politics—handing out goodies to a favoured few—can end up hurting as many members of the group as it helps, so it becomes less tempting.

Reuters

Mayawati favours her own

Members of the middle class agree on a few basic things. Because they have a stake in the economy and want things to be better for their children, they support pro-growth policies: cautious liberalisation, investment in public goods, open trade. Because their assets are small compared with those of the rich, and comparatively vulnerable to reversals, they tend to be risk-averse, wary of inflation and opposed to economic populism. With the strange exception of Argentina, the middle classes of Latin America are bulwarks of economic orthodoxy and fiscal rectitude.

New York University's Mr Easterly has found that the larger a country's middle class, the lower its indicators of every sort of instability, be it revolutions and coups, outbreaks of civil war, constitutional changes or suppression of civil rights. Which is the cause and which the effect, however, is not so clear.

When an autocracy brings stability, as it has done in China, an approving middle class may be less likely to insist on democracy. But when democracy becomes established, the middle class usually turns into a strong supporter. Latinobarómetro, a polling organisation, found that, in the period from 2001 to 2008, support for democracy rose in 12 of the 18 Latin American countries that have it; most respondents also thought democracy provided the only road to development.

That does not necessarily turn the middle class into a force for democracy and stability. Eventually it brings its own discontents which, as the group becomes a majority, dominate politics: disputes over land (emerging markets abound with historic land-holding patterns that conflict with the interests of the middle class); disagreements over the role of women (middle-class women go out to work more, and have smaller families, causing conflicts with groups committed to traditional ways of life); and so on.

But the more immediate question is not how much disruption will be caused by the growth of the middle class but by its possible decline, at a time when global recession is pushing some of those who have just joined it back into poverty. That is the subject of the last article.

Suspended animation

Feb 12th 2009
From The Economist print edition

The recession may bring middle-class growth to a halt for a while—but not for long

OVER the next two or three decades, an expanding global middle class could boost economic growth and encourage democracy (or at least more liberal politics). It could also press for global public goods, such as tougher limits on greenhouse-gas emissions (middle-class people are more inclined than others to worry about the environment). But the main question about the middle class in the immediate future will be different: how badly will it be hit by a global recession?

Since the Asian currency crisis of 1997-99, the middle classes in emerging markets have known nothing but success. For most of them even that currency crisis was just a blip. China's and India's mass middle classes have seen only uninterrupted growth. But the period of rising prosperity is coming to an abrupt end.

Economic growth is slowing much more than anyone had expected only a few weeks ago. China's GDP growth more or less came to a halt in the last quarter of 2008 and many economists are forecasting the feeblest expansion for 20 years in 2009. At the end of 2008 exports from emerging markets were falling at an annual rate of more than 10%. Industrial output is collapsing and many Asian countries face the worst recession since 1997-99.

Against that unpropitious background, three emerging-market giants face elections in the next two years: India, a parliamentary vote by May this year; Indonesia, congressional and presidential votes in mid-2009; and Brazil, a presidential election in October 2010. Other big middle-income countries with elections in the next two years include Argentina, Chile, Colombia, Hungary, Poland, South Africa and Ukraine. China's rulers too have long been worrying about retaining the support of the middle class. Anniversaries in 2009—the 20th of the Tiananmen Square uprising; the 50th of the crushing of Tibetan independence—may provoke protests.

A reversal of middle-class fortunes could have serious effects. As this report has argued, the new middle classes contribute a lot to a country's growth, efficiency and equity—as consumers, as investors in "human capital" and because they engage in a wider range of economic activities than the rich and are more likely to create jobs than the poor. They also tend to promote liberalisation and, indirectly, democracy by moving their countries away from the politics of patronage. All these good things would be at risk if they were hurt by recession.

Magnum Photos

A better class of kitchen sink

There are several reasons for thinking the middle could be more vulnerable to the global recession than the extremes. Though the rich are the most exposed to losses on equity and financial markets, they also have a much greater capacity to absorb the blows, since they have more, and more diversified, assets. As for the poor, the very things that have prevented them doing better in the past 15 years—distance from world markets, lack of exposure to trade—might now come to their rescue. Poverty cushions them from the losses as well as the gains of globalisation.

In contrast, the middle class faces problems across the board: jobs (its members are more likely than the poor to be employed by companies that depend on exports or outsourcing); assets (they have invested in property and shares but house prices and stockmarkets have crashed); and finance (they have put their money in banks or have borrowed from credit companies that are exposed to global markets).

The main relief for the middle class is that many of its members have jobs in the public sector, which can resort to deficit spending. For the moment, therefore, the usual rule that a middle class based on the private sector tends to do better than one which feeds off the public sector may have been suspended.

A second reason for thinking that the middle class may be especially vulnerable is that the largest group within it is dangerously close to the poverty line. This report has argued that in recent years the middle class has surged, not merely expanded along with economic growth. As the fat part of the bell curve of income inequality moves beyond the middle-class threshold, huge numbers are lifted out of poverty. Yet many of them are still perilously close to the borderline.

Slippery slope

Martin Ravallion of the World Bank separates the developing-world middle class (those on $2-13 a day) into upper and lower tiers, with $9 a day as the dividing line. On his calculations, the numbers in the upper tier ($9-13 a day) rose by only 95m between 1990 and 2005, from 139m to 233m. Yet the number of middle-class people as a whole during that period increased by 1.2 billion, so more than ten times as many people joined the lower tier ($2-9 a day) as joined the upper. Most of them cluster at the very bottom. In 2005, estimates Mr Ravallion, one person in six in emerging markets was living on $2-3 a day. Such people have only a tenuous hold on middle-class status and risk slipping backwards.

A third reason for worry, argues Homi Kharas of the Brookings Institution, is that the middle classes might “misinterpret the recession”. For most of them, the lesson of the past 20 years has been that good things happen when a country opens up and bad things occur when it turns inward (eg, China’s Cultural Revolution or Brazil’s military coups). But a period in which emerging countries import recession from rich ones could change people’s attitudes.

In Russia the instability of the Yeltsin years convinced many that the country would be better off if it became more self-reliant. And in 2007-08, as food prices spiked, governments around the world, including the emerging markets, reacted by imposing export bans, export taxes and many other forms of trade protection.

Moreover, some countries seem more vulnerable to a global recession than others. Brazil and Russia are sensitive to raw-material prices, which are falling. The World Bank forecasts that the volume of international trade will decline in 2009, for the first time since 1982. This will hit countries heavily dependent on exports. Most large emerging nations have built up foreign-exchange reserves and cut their external debts, which will provide a measure of protection. But that is not true of eastern Europe, where reserves have been flat and external debts rising.

For all these reasons, it seems more likely that the new middle classes will be victims of recession, rather than the people to haul the world out of trouble, as the World Bank hopes. But the bigger question is whether the slump will undermine the essential qualities of middle-class behaviour—the propensity to save, to invest in the children's education and so on. The answer to that depends in part on how long the slump lasts. Most developing countries, including the two largest, China and India, expect some growth in the next two years, albeit much less than in 2000-07. Moreover, retail sales tell a slightly less gloomy story and may be better indicators of the mood of the middle class than GDP growth. In China and India they held up surprisingly well in 2008, suggesting that consumers have not gone into their shells.

Panos

The way it was, and will be again

Much will also depend on public policy, especially in the emerging-market giants. The reactions of the Chinese and Indian governments have been "mature", says Eswar Prasad of Cornell University. In November 2008 China produced a multi-billion-dollar government-spending plan which aims to restore GDP growth to over 8% in 2010. It has plenty of room to increase domestic demand. In India, the picture is more mixed: the country has imposed some restrictions on goods imports but has also liberalised its financial sector.

In general, support for globalisation among the Chinese, Indian and Brazilian middle classes does not yet seem to be waning, as it has done in Russia. That may be because so many people have benefited over the past 15 years that it will take a lot to persuade them to back any radical departures from the way things are. Certainly, few observers expect the coming elections in the three biggest emerging countries to bring drastic changes. India's is likely to produce yet another relatively weak coalition government, led by one of the two main parties. Because of Indonesia's complex electoral system, the presidency is most likely to go to the current incumbent or his predecessor, both from secular, mainstream parties. Brazil's election is too far away for a sensible forecast to be made, but since the incumbent president (who is prevented by term limits from standing again) has an 80% approval rating, a rebellion against the status quo looks unlikely.

See you in a couple of years

This survey has argued that, to misquote Scott Fitzgerald, the middle class is different: meritocratic, thrifty, individualistic, committed to education. Some of these attributes and attitudes may be permanent, or at least only partially subject to the vagaries of the economic cycle. Admittedly there is little hard evidence from emerging markets to support or contradict this assertion. But the middle classes in America and Europe do not seem to have changed their outlook radically during slumps. People have

usually sought to keep their children in private education as long as they can, for example, cutting back on consumption instead. The spread of the internet and mobile phones may also have reinforced the middle class's fear of being cut off from the technology and information on offer in the rest of the world.

So if—perhaps a big if—the global recession lasts no more than a couple of years, it seems reasonable to expect the engine of middle-class formation to start humming again when growth picks up. There will be another portion of Maslow's pyramid to climb, another political system to change, another step to take towards a global middle class. Until then, there will be a pause, but not an end, to what Marx called "the most revolutionary part" the middle class has played in human affairs.

Sources and acknowledgments

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Offer to readers

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Electronic-book readers

Well read

Feb 12th 2009 | SAN FRANCISCO
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Electronic books are becoming popular. Will newspapers follow?

Amazon

JEFF BEZOS, Amazon's boss, pays attention to symbolism. He named his e-commerce company after the world's largest river to suggest a flood of books and other products. He named Amazon's e-book reader, launched in 2007, the Kindle to suggest that it would spark a fire (and not of the book-burning sort). This week he unveiled the Kindle 2, an improved version for the same $359, against the backdrop of a library that was once the private collection of John Pierpont Morgan. Assisting him was Stephen King, a popular author who has written a novella that will be available only on the device. The Kindle 2, Mr Bezos means to say, is about preserving a great tradition—book reading—and improving it, not about replacing it.

In many ways, this is true. The Kindle is an unusual gadget in that it does not obviously target young people, or early-adopting technophiles. Instead it appeals to passionate readers, who want no fiddling with cables (the Kindle works without a computer) or complicated pricing plans (Kindle users pay to buy books and other content, but do not have to pay wireless-subscription fees). It is, in short, perfect for older people. The Kindle is a surprisingly "conservative" device, says John Makinson, the boss of Penguin Group, a large book publisher, so it is an additional distribution channel and thus "good for us". (Penguin is an arm of Pearson, which partly owns *The Economist*.)

Steve Kessel, a member of Amazon's Kindle team, says that Kindle owners seem to read more. "It's the convenience—they think of a book and can be reading it within 60 seconds," he says, thanks to the instant wireless downloads, and "they're now carrying all their books around with them all the time." The Kindle 2 can hold about 1,500 books, and one battery charge allows two weeks' reading. And since the screen is not backlit but imitates real ink and paper, Kindle owners can read for hours without straining their eyes.

So far, says Mr Kessel, this does not seem to spell the end of paper books, since Kindle users buy just as many bound books as before, so that their total consumption of books goes up by 2.6 times. That may change as more titles become available. More importantly, the Kindle and similar devices made by Sony and others represent only one side of the evolving e-reader market. They are for aficionados, since paying $359 for a device makes sense only if you read quite a lot of books, newspapers or magazines on it.

For everybody else, such as infrequent readers and the young and cash-strapped, the mobile phone may become the preferred e-reader. A popular software application on Apple's iPhone, called Stanza, already turns that device into a book reader, with one-handed page turning that is ideal for public transport. A

backpacker who consults his “Rough Guide” for snippets of up-to-date information in a dark tent is unlikely to tote along a Kindle and a lamp, or a paper book, if he can get the e-book on his backlit phone.

It is now only a matter of time until absolutely all books become available, and properly formatted, for mobile phones. Google, an internet giant that has been scanning and digitising books for inclusion in its search engine, now offers thousands of books that are in the public domain free on mobile phones. It seems likely that, eventually, only books that have value as souvenirs, gifts or artefacts will remain bound in paper.

Newspapers and magazines are on the same trajectory. Their paper editions are in decline in most of the developed world, as readers opt for the web versions on their computers and laptops, or on smart-phones such as the iPhone. The Kindle could accelerate that shift since it also lets users subscribe to news publications, which are automatically delivered.

All this has led to a new phrase in the book and newspaper industries: Is this the “iPod moment”? It is a layered and loaded analogy. On the one hand the iPod, Apple’s now legendary music-player, and its associated iTunes store opened up a new market for legal digital-music downloads. On the other hand, the iPod accelerated the decline in CD sales and shifted power from record labels to Apple. Will the Kindle similarly put Amazon in a dominant position, while weakening publishers?

This is unlikely. Books, says Penguin’s Mr Makinson, are different from music. Sales of CDs were harmed because iPod users could “unbundle” the albums that record labels had forced on them, and download only the songs they wanted. By contrast, there is no obvious reason to unbundle narrative books into individual chapters or paragraphs. A book sold via a Kindle thus has no marginal cost, but adds revenues. Another difference is that music was being widely pirated before Apple made legal downloading attractive. There is no such crisis in the book business.

Nor is Amazon likely to achieve anything near Apple’s power over the music industry. True, when a newspaper or magazine reader drops his paper for a Kindle subscription, he enters a billing relationship with Amazon rather than the publisher. (Neither Amazon nor its partners will reveal how the revenue is split.) But for record labels, Apple was the only viable and legal route. For the news industry, says Craig McKinnis at *USA Today*, a large American daily, the Kindle is “just one of the splinters” among many new distribution channels, from the web to mobile-phone applications to e-readers. What happened in music “I cannot imagine taking place” in news, he says.

Indeed, the Kindle and other e-readers could be a boon to newspapers. With rare exceptions, newspapers have accustomed their readers to expect digital editions to be free. As circulation revenue has declined, this made them dependent on advertising, just as the recession hit. On the Kindle, by contrast, the news has no ads. Instead, readers seem happy to pay for it—just as they pay for services in any other industry that offers something worthwhile.

News agencies

High wires

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From The Economist print edition

With newspapers in crisis, newswires may learn to live without them

WHERE does news come from? The answer, much of the time, is from newswires. Many of the stories in newspapers, on television, radio and online are based on dispatches filed by the big news agencies. The biggest international newswires, Associated Press (AP) and Reuters, date back to the expansion of the telegraph in the mid-19th century, when rapid newsgathering first became possible. The agencies have usually been wholesalers of news; newspapers, broadcasters and websites act as retailers, repackaging and selling news to consumers alongside material generated in-house.

Some, such as AP (a co-operative owned by its subscribers) and the state-backed French News Agency (AFP), have stuck to that model. But Reuters, like the Dow Jones newswire (which grew out of the *Wall Street Journal*), has developed a huge business providing information to financial-services firms, for which rapid, accurate news is highly valuable. A more recent arrival, Bloomberg, started out as a provider of such information but has turned into a news agency as well, creating a worldwide network of bureaus and syndicating stories to newspapers.

The financial crisis is taking a terrible toll on both financial-services firms and newspapers, so you might expect the news agencies that serve them to be in trouble too. Not so. Christoph Pleitgen, a senior Reuters executive, says the big newswires have been staffing up in the past year. The *Journal*'s owner, News Corp, announced job cuts at the newspaper earlier this month, but said that the Dow Jones newswire was adding journalists at its bureaus, especially in India. Likewise, Bloomberg's recent announcement of around 190 job cuts at a foreign-language television venture got more attention than its promise to create 1,000 jobs elsewhere, including in its news bureaus. And CNN, a television-news network, plans to set up a new international agency to rival AP and Reuters.

A few struggling newspaper groups have stopped subscribing to newswires. Many others, having cut their own newsrooms, have become more dependent than ever on regurgitating agency copy. The proliferation of news websites, hungry for content, but lacking staff to produce it themselves, has also boosted the agencies. Last year printed newspapers contributed only 25% of AP's revenues, says its boss, Tom Curley, down from 55% in 1985. Mr Pleitgen says that in developing regions, such as the Gulf, new television stations, websites and even newspapers are springing up, compensating for the newswires' loss of customers elsewhere.

But if newswires are thriving and newspapers are making ever more use of wire copy, why don't the wire services supply news direct to the consumer? The risk that newspapers will be disintermediated is noted in a new report by, of all people, the Reuters Institute for the Study of Journalism at Oxford University. In some ways, it is already happening. Reuters and Bloomberg offer their top stories direct to consumers on advertising-financed websites.

And as more people consume news via smart-phones and other mobile devices, the newswires are providing it there, too. Norman Pearlstine, a senior Bloomberg executive, says the firm's application for the Apple iPhone has been downloaded over a million times. Its service is free "for now". AP, which is owned by its main subscribers, is treading carefully: it has struck deals with 1,200 American newspapers to create mobile websites, for which AP provides national and international news and they provide local news.

Nobody yet knows which business model, if any, will work for mobile news. Mr Pearlstine notes that mobile users happily pay for a new ringtone, so why not for news? It is unclear how good news agencies will be at marketing direct to consumers. But as they continue building their worldwide news bureaus and providing more comprehensive coverage, they may be more likely to survive in the long term than those newspapers which, through constant rounds of cuts, risk becoming ever less distinctive.

The film industry

Cinderella story

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From The Economist print edition

Two of Hollywood's biggest brands form an unexpected partnership

LATELY DreamWorks SKG has been a wandering tribe. The would-be studio, which made films such as "American Beauty" and "War of the Worlds", sold itself to Paramount in 2005. When that arrangement fell apart it found new partners in Reliance Big Entertainment, a Bollywood outfit, and Universal Studios. Then it fell out with Universal. So it was rather a surprise when, on February 9th, DreamWorks abruptly found itself in the promised land. Disney, the world's foremost purveyor of wholesome entertainment, lent it money and agreed to market and distribute its films.

It is a good illustration of how the economic downturn is affecting Hollywood. Until recently executives were boasting that the film business was resistant, perhaps even immune, to recession. The number of cinema tickets sold actually increased during three out of the past four recessions. Box-office receipts so far this year are higher than last year. Admittedly, the share prices of media companies have tumbled—but that is because of the collapse in television and print advertising, and has little to do with Tinseltown.

Yet the downturn has profoundly affected the art of dealmaking. Although the breakdown of negotiations between DreamWorks and Universal has been followed by a storm of recriminations, the heart of the problem was that DreamWorks was finding it unexpectedly hard to raise debt. It is hardly alone in that. Two years ago investors were lubricating all sorts of strange alliances and start-ups—Tom Cruise wants to resurrect United Artists? Why not? But now the outside money has all but disappeared. The big studios, the primacy of which was never exactly threatened during the boom years, are now almost the only game in town.

The alliance with DreamWorks is something of an about-turn for Disney. Under Bob Iger, who took over as chief executive in 2005, Disney has culled films that are a less than perfect fit for its family-friendly brand and has concentrated on turning those that are into amusement-park rides, lunch boxes and other spin-offs. This week's deal will add as many as six films a year to Disney's pipeline, swelling it by about half. The surge will not happen at once, however: DreamWorks will have to raise more money before it is capable of producing that many.

These days DreamWorks is largely Steven Spielberg's outfit. Jeffrey Katzenberg (the "K" in SKG) runs DreamWorks Animation, a separate, publicly owned company. David Geffen (the "G") has retired from the studio. The remaining founder spoke warmly of Disney this week, calling it the "birthplace of imagination". He is said to be looking forward to making more family films. Perhaps, but he still looks a little out of place in the magic kingdom.

Bloomberg News

Spielberg takes a low-cost approach

Mr Spielberg became America's best-known, and perhaps best, film director by fusing blockbuster spectacle with an unflinching take on family life. The households even in his PG-rated films are almost uniformly dysfunctional. Think of Richard Dreyfuss flinging plants through the window in "Close Encounters of the Third Kind", Frances O'Connor abandoning her adopted robot son by the roadside in "A.I." or the defeated, self-deluding Christopher Walken in "Catch Me If You Can". It is hard to imagine any of them donning Mickey Mouse ears.

Rio Tinto and Chinalco

Undermined

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The crash in commodity prices lets China grab a prize

IT WAS a deal Rio Tinto had been resisting for months. But in the end, every other option must have seemed worse. Rio is buried under a huge debt burden after heavy investment in capacity during the suddenly vanished commodity boom, and its purchase of Alcan in 2007. With the financial markets all but closed, the mining giant was up against the wall.

For China, flush with cash and looking for guaranteed sources of commodities to feed its factories and mills, it was an opportunity that had as much to do with geopolitical strategy as financial investment. On February 12th the Aluminum Corporation of China (Chinalco), a state-owned enterprise, announced that it would invest $19.5 billion in Rio, in two tranches. Chinalco will pay $12.3 billion for stakes of up to 50% in nine of Rio's mining assets, and will also buy $7.2 billion of bonds convertible into shares, in effect giving it the right to own just under 20% of Rio.

The total, coincidently or not, is sufficient to pay off debts maturing over the next two years—a period that Rio's chief executive, Tom Albanese, warned would probably be "difficult", which was putting it mildly. Chinalco said its investment would be financed by Chinese financial institutions, adding that there had already been various discussions—which suggests that the government has already granted its approval.

Rio's shareholders are likely to have mixed feelings. The price offered for the assets was as much as 124% above their market value, according to the firm, though it is probably just a fraction of what could have been achieved only months ago when BHP Billiton was pursing a takeover. Alternative methods of financing, notably a rights offering, would have certainly been dilutive and, according to Mr Albanese, perhaps not even feasible. In apparent disagreement was James Leng, chairman of Corus, a big steelmaker. Mr Leng abruptly announced his resignation as Rio's chairman-designate on February 9th.

Whether the deal will go ahead now hinges on political considerations. Australia's Foreign Investment Review Board has been wary of offers from Chinese state-owned enterprises, particularly if they give the buyer some sort of pricing or production power. On February 12th the finance minister said the government wanted to amend its takeover laws to go beyond straightforward acquisitions and encompass complex investments—a fair description of the Rio-Chinalco deal and others percolating under the surface.

The truck industry

A long haul

Feb 12th 2009
From The Economist print edition

Truckmakers are suffering, but their future is not entirely bleak

IF THE car business is in meltdown, things are only marginally better for truck manufacturers. The results just posted by the two Swedish giants of the industry, Volvo and Scania, painted a picture of collapsing orders with little respite in sight. When Daimler, the world's biggest truckmaker, and MAN, the fourth-largest, report next week, they are expected to confirm that the industry is facing one of the worst busts in its history.

It was not supposed to be like this. Just 18 months ago the collective valuation of the world's big truckmakers reached an all-time high, having doubled in less than two years. Some within the industry even suggested that it had achieved a "new paradigm" of stable, long-term growth, in sharp contrast to the violent cyclical swings of the past. The theory was that booming emerging markets, such as eastern Europe, South America, the Middle East and North Africa, would compensate for fluctuations in mature markets. A more disciplined approach to supply and pricing was also thought to have helped, and the convergence of regional emissions regulations over the next few years would, it was said, at last allow the biggest producers to realise scale economies that had previously eluded them.

Unfortunately, as so often when people start talking about new paradigms, a collision with the unexpected was lurking round the next corner. In the last quarter of 2008 Scania saw truck orders decline by 84% year-on-year in western Europe and actually go negative (as orders were cancelled) in emerging markets.

Volvo, which reported an 82% drop in orders in the same period, seems to have reacted more swiftly than its peers by slashing production as soon as it saw the downturn in Europe, the most savage in more than 20 years. Others have since taken similar action: MAN will shut down production for 70 days during the first half of this year in anticipation of a market contraction of more than 30%. But the industry is now locked in a downward spiral of falling earnings and increasingly bloated inventories that threatens to weaken pricing for some time to come.

HSBC forecasts that global demand for heavy trucks of more than 15 tons will fall by 29% this year. It expects a 24% drop in developed markets and a 32% fall in emerging ones. But despite this grim short-term outlook, the industry is in better shape to withstand the battering than many of the car firms. With the possible exception of Volvo, which is relatively highly geared, the global manufacturers are unlikely to have to raise money from shareholders. Unlike the carmakers, truck companies earn at least 25% of their revenues from high-margin service operations that are unaffected by the cycle, notes David Cramer, an analyst at Morgan Stanley.

Reuters

Mortal

The industry can also take heart from a number of trends that should help it in the medium term. In most markets, but especially North America, the steep fall in fuel prices has restored some profitability to truck

operators, and with it their ability to replace ageing equipment. At 7.5 years, the average age of the American fleet is the highest for more than two decades.

The industry will also get a boost from ever-tightening emissions regulations. Europe's new Euro 5 rules come into effect in October, and America's EPA-10 rules next January. India and China are also moving to cleaner engines. When Europe adopts the Euro 6 standard in 2012, the emissions rules of all the developed markets will at last have converged, giving global manufacturers a return on years of expensive development and ending the need for a multiplicity of engine platforms.

Another positive sign is the emphasis on infrastructure spending in many of the national fiscal stimulus packages. Big construction projects are good for the heavy and specialist truck industry, and better roads in emerging economies will eventually create new demand.

Finally, a further bout of consolidation will begin when liquidity eases. The first mover is expected to be Porsche, which now controls Volkswagen, which, in turn, is the largest shareholder in both Scania and MAN. Last month MAN completed the purchase of VW's Brazilian truck business, and MAN's chief executive, Hakan Samuelsson, is still keen to join forces with his former employer, Scania, having failed in a hostile bid in 2006. Smaller firms, such as Navistar in America and Fiat's Iveco, could find themselves as targets.

Truckmakers are unlikely to see a return to the heady expansion they enjoyed for a few years until 2007. HSBC reckons that the industry will be back to solid (if not sensational) growth by 2011, but that the ranks of big, developed-world truck firms will have been culled from ten in 2008, when Caterpillar pulled out, to just six: Cummins, Daimler, Hino, MAN, Paccar and Volvo.

Corporate etiquette

Manners maketh the businessman

Feb 12th 2009 | PARIS
From The Economist print edition

The economic crisis prompts an outbreak of politeness in business

WHEN Andrew Chadwick-Jones, a management consultant with Oliver Wyman in London, went to pitch to a private-equity firm late last year, he expected the usual: about 20 minutes and a brisk attitude. He was surprised to find the private-equity people instead explaining their strategy, offering introductions to senior staff and being more open and friendly. “Now that money and deals are scarce, they’ve got to be nicer to all the people they interact with, in case they might help bring business in future,” he says.

Rudeness is out, and civility is the new rule in an uncertain world. The former kings of abrasive behaviour—Masters of the Universe bankers, hedge-fund traders, private-equity chiefs—have been humbled. On Wall Street, says a banker, “it’s now all about charm and openness and taking time with people.” Cocky young things straight out of the best business schools have stopped skipping interview appointments, recruiters say, and there is much less looking over people’s shoulders at drinks parties, reports one veteran. Many people, fearful for their jobs, are trying to burnish their contacts at other firms.

The change in tone also reflects an upheaval in the balance of power between companies. Before the crisis, says Michel Péretié, head of investment banking at Société Générale in Paris, he would go and see a senior chief executive with a mergers-and-acquisitions idea, get in for a short while and, on the way out, walk past a line of all his competitors. Now, he says, “You’re ushered in, you get an hour with the CEO and he walks you to your car.” As the representative of a bank with money to lend, Mr Péretié is now the chief executive’s potential saviour. “During this crisis, when there is so much uncertainty about who will end up having power, the best strategy is to be civil to everyone,” says Adam Galinsky of the Kellogg School of Management at Northwestern University.

People have more time to be friendly when business is slow. Some reckon the new cordiality reflects a feeling that everyone is in the same boat: when some firms have to fire good performers as well as bad, no one is safe. But if people at different firms are being nicer to each other, things may not be getting any nicer inside companies. At many, stress and in-fighting are on the rise because of the threat of job cuts. And as soon as things turn up again, all agree, the extra niceness will vanish.

Face value

Back to the future

Feb 12th 2009
From The Economist print edition

John Monks says trades unions should press for a return to more old-fashioned capitalism

AFP

AS BRITISH construction workers went on strike this month to protest against Italian and Portuguese employees being brought in to British building sites, an unexpected voice spoke up to defend the free movement of labour within the European Union (EU). John Monks is a former leader of the British Trades Union Congress (TUC) who now heads the European Trade Union Confederation. He pointed out that there were British lift engineers working at a hotel where he was drinking in Brussels—and, moreover, that there were usually more British contractors working abroad than foreigners in Britain. He has some reservations about the “posted workers” rules that govern such matters. But this was, he declared, no time for protectionism over jobs.

The boss of Europe’s unions may seem an unlikely standard-bearer for free-market capitalism. But Mr Monks thinks unions have an important role to play as capitalism is reshaped by the financial crisis. More of a thoughtful administrator than a bombastic leader, he never really liked the language of antagonism that pitted labour against capital and saw collective-bargaining agreements as merely a truce in the class war. He was always much happier with the consensual style of unionism in continental Europe, where workers—especially in Germany—were consulted on decision-making at firm and factory level. He welcomed the growth of a pragmatic, peaceful approach in Britain after Margaret Thatcher crushed militant unionism in the 1980s.

Mr Monks’s view of capitalism was forged in the corporatist 1950s world of Imperial Chemical Industries (later ICI), with its generous pensions, fringe benefits, profit-sharing and so on. Having grown up in the shadow of an ICI factory near Manchester and studied economic history, he thought that was how things would always be. Despite his ten years heading the TUC, he had no idea how fundamentally that model of sober capitalism was being overtaken. Mr Monks confesses shamefacedly that until his daughter’s boyfriend joined a hedge fund in 2005 he had no idea how modern finance worked. As the young man explained hedge funds, private equity, mezzanine finance, leveraged deals and short-selling, Mr Monks’s eyes widened. Gradually it dawned on him why the solid old industry scene of ICI and General Motors was going, well, the way of ICI and GM.

Up until this point he had assumed that he was just reshaping trade unions to face a world where industrial jobs and union membership were in decline. Trade unionism is in retreat across Europe: in Britain and Germany the number of union members has fallen by roughly half since 1980. German unions tolerated years without increases in real wages as Germany struggled to remain competitive after the launch of the euro. In France unions are confined to the public sector and to partly state-owned companies, such as Suez-Gaz de France and Renault. Steelworks, coal mines and shipyards were once the

heart of British unionism, but now Tesco is Britain's biggest employer of unionised labour, with 140,000 unionised workers in its shops and depots. Mr Monks realised that there were more fundamental forces at work—such as the rise of modern financial capitalism and the single market.

The EU, influenced by centre-left thinking among social democrats and Christian democrats, has tended to favour a "social Europe" that softens the hard edges of capitalism as practised in America or Britain. But a European Court of Justice ruling in December 2007 appeared to unionists to place the free movement of labour above the interests of unions and national collective-bargaining deals. In an obscure dispute over a Latvian firm employing cheap Latvian labourers on a Swedish building site, the EU's highest court ruled that the right to strike is not as important as the free flow of labour, goods and services. In interpreting this posted-workers directive, the court came down in favour of the Latvian firm, and against Swedish strikers. Even before a similar row erupted in Britain, Mr Monks worried that the directive was being interpreted in a way that threatens harmonious labour relations. His enthusiasm for the free movement of labour is tempered by fear that it could undermine national wage agreements.

Turning back the clock

The economic crisis, he believes, means the conditions are now ripe for a union counter-attack—not to undermine capitalism, but to reshape it and regain influence. Mr Monks was astonished to learn that investors could sell shares they did not own, only to buy them for less when their actions had driven down the price. What disgusts him even more is that the wilder fringes of financial capitalism are populated not only by hedge funds, private equity and other speculators (in a nod to Irish politics, he calls them "the provisional wing of financial services"), but by mainstream banks. He regrets that even unionists—through their interest in pension funds—are caught up in the pursuit of high returns. But he reserves his strongest criticism for the City of London where he sees investors interested only in elaborate speculation, and unwilling to take risks on backing ordinary businesses. At least in America, he notes admiringly, venture capitalists are usually ready to back innovative start-ups.

He would like to see the patient approach of investors like Warren Buffett come back into style, as part of a broader return to a more old-fashioned form of capitalism. He approves of the way German and Italian banks support small and medium-sized companies. He is a great admirer of the boss of Rolls-Royce, Sir John Rose, who has been waging a campaign to get the British government to take manufacturing more seriously. And he notes that the obsession with short-term results means that for years, it has been no fun being boss of a British public company. "Two bad quarters and you are out", he says, has been the way for too long. Before the crisis, expressing such scepticism towards modern finance sounded Luddite and anti-capitalist. But now Mr Monks finds himself in the mainstream—and hopes to capitalise on it.

Irving Fisher

Out of Keynes's shadow

Feb 12th 2009 | WASHINGTON, DC
From The Economist print edition

Today's crisis has given new relevance to the ideas of another great economist of the Depression era

Sue Vago

SHORTLY after he was elected president, Barack Obama sounded a warning: "We are facing an economic crisis of historic proportions...We now risk falling into a deflationary spiral that could increase our massive debt even further." The address evoked not just the horror of the Depression, but one of the era's most important thinkers: Irving Fisher.

Though once America's most famous economist, Fisher is now almost forgotten by the public. If he is remembered, it is usually for perhaps the worst stockmarket call in history. In October 1929 he declared that stocks had reached a "permanently high plateau". Today it is John Maynard Keynes, his British contemporary, who is cited, debated and followed. Yet Fisher laid the foundation for much of modern monetary economics; Keynes called Fisher the "great-grandparent" of his own theories on how monetary forces influenced the real economy. (They first met in London in 1912 and reportedly got along well.)

As parallels to the 1930s multiply, Fisher is relevant again. As it was then, the United States is now awash in debt. No matter that it is mostly "inside" or "internal" debt—owed by Americans to other Americans. As the underlying collateral declines in value and incomes shrink, the real burden of debt rises. Debts go bad, weakening banks, forcing asset sales and driving prices down further. Fisher showed how such a spiral could turn mere busts into depressions. In 1933 he wrote:

Over investment and over speculation are often important; but they would have far less serious results were they not conducted with borrowed money. The very effort of individuals to lessen their burden of debts increases it, because of the mass effect of the stampede to liquidate...the more debtors pay, the more they owe. The more the economic boat tips, the more it tends to tip.

Though they seldom invoke Fisher, policymakers in America are applying his ideas. In academia Ben Bernanke, now the chairman of the Federal Reserve, sought to formalise Fisher's debt-deflation theory. His research has shaped his response to this crisis. He decided to bail out Bear Stearns in March 2008

partly so that a sudden liquidation of the investment bank's positions did not trigger a cycle of falling asset prices and default. Indeed, some say the Fed has learnt Fisher too well: from 2001 to 2004, to contain the deflationary shock waves of the tech-stock collapse, it kept interest rates low and thus helped to inflate a new bubble, in property.

Were Fisher alive today, "he would tell us we have to avoid deflation, and to worry about all that inside debt," says Robert Dimand, an economist at Brock University in Canada, who has studied Fisher in depth. "The ideal thing is to avoid these situations. Unfortunately, we are in one."

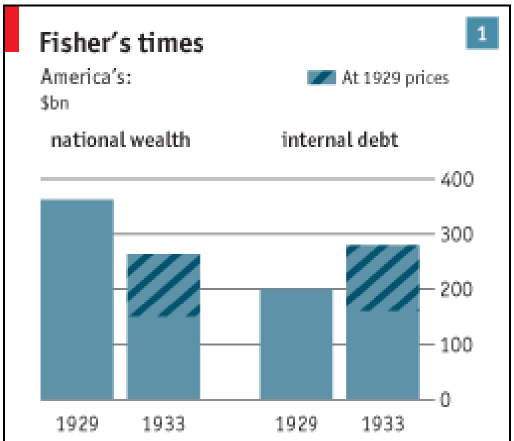
Fisher was born in 1867 and earned his PhD from Yale in 1891. In 1898 he nearly died of tuberculosis, an experience that turned him into a lifelong crusader for diet, fresh air, Prohibition and public health. For a while he also promoted eugenics. His causes, both healthy and repugnant, combined with a lack of humour and high self-regard, did not make him popular.

In 1894, on a trip to Switzerland, he saw, in water cascading into mountain pools, a way to "define precisely the relationships among wealth, capital, interest and income," Robert Loring Allen, a biographer of Fisher, wrote. "The flowing water, moving into the pool at a certain volume per unit of time, was income. The pool, a given volume of water at a particular moment, became capital." Over the next 30 years he established many of the central concepts of financial economics.

In 1911, in "The Purchasing Power of Money", Fisher formalised the quantity theory of money, which holds that the supply of money times its velocity—the rate at which a dollar circulates through the market—is equal to output multiplied by the price level. Perhaps more important, he explained how changing velocity and prices could cause real interest rates to deviate from nominal ones. In this way, monetary forces could produce booms and busts, although they had no long-run effect on output. Furthermore, Fisher held that the dollar's value should be maintained relative not to gold but to a basket of commodities, making him the spiritual father of all modern central banks that target price stability.

During the 1920s Fisher became rich from the invention and sale of a card-index system. He used the money to buy stocks on margin, and by 1929 was worth $10m. He was also a prominent financial guru. Alas, two weeks after he saw the "plateau" the stockmarket crashed.

To his cost, Fisher remained optimistic as the Depression wore on. He lost his fortune and his home and lived out his life on the generosity of his sister-in-law and Yale. But his work continued. He was prominent among the 1,028 economists who in vain petitioned Herbert Hoover to veto the infamous Smoot-Hawley tariff of 1930. And he developed his debt-deflation theory. In 1933 in *Econometrica*, published by the Econometric Society, which he co-founded, he described debt deflation as a sequence of distress-selling, falling asset prices, rising real interest rates, more distress-selling, falling velocity, declining net worth, rising bankruptcies, bank runs, curtailment of credit, dumping of assets by banks, growing distrust and hoarding. Chart 1 is his: it shows how deflation increased the burden of debt.



Source: Irving Fisher, "The Debt-Deflation Theory of Great Depressions", *Econometrica*, 1933

Fisher was adamant that ending deflation required abandoning the gold standard, and repeatedly implored Franklin Roosevelt to do so. (Keynes was of similar mind.) Roosevelt devalued the dollar soon after becoming president in 1933. The devaluation and a bank holiday marked the bottom of the Depression, though true recovery was still far off. But Fisher had at best a slight influence on Roosevelt's decision. His reputation had fallen so far that even fellow academics ignored him.

Contemporary critics did poke a hole in his debt-deflation hypothesis: rising real debt makes debtors worse off but creditors better off, so the net effect should be nil. Mr Bernanke plugged this in the 1980s. "Collateral facilitates credit extension," he said in June 2007, just before the crisis began in earnest. "However, in the 1930s, declining output and falling prices (which increased real debt burdens) led to widespread financial distress among borrowers, lessening their capacity to pledge collateral…Borrowers' cash flows and liquidity were also impaired, which likewise increased the risks to lenders." Mr Bernanke and Mark Gertler of New York University dubbed this "the financial accelerator".

The downward spiral can start even when inflation remains positive—for example, when it drops unexpectedly. Consider a borrower who expects inflation of 2% and takes out a loan with a 5% interest rate. If instead inflation falls to 1%, the real interest rate rises from 3% to 4%, increasing the burden of

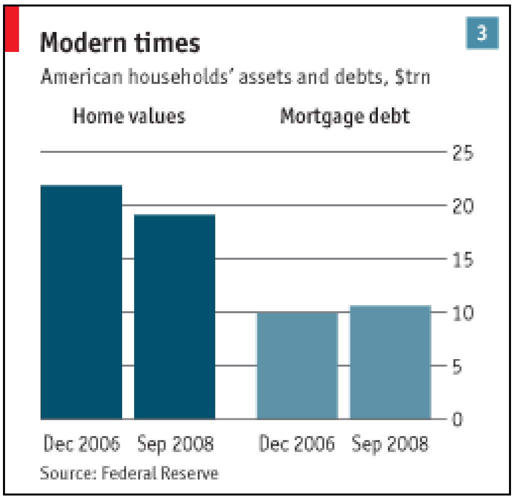
repayment.

Asset deflation can do much the same thing. If house prices are expected to rise by 10% a year, a buyer willingly borrows the whole purchase price, because his home will soon be worth more than the loan. A lender is happy to make the loan for the same reason. But if prices fall by 10% instead, the house will soon be worth less than the loan. Both homeowner and lender face a greater risk of bankruptcy.

Today, debt in America excluding that of financial institutions and the federal government is about 190% of GDP, the highest since the 1930s, according to the *Bank Credit Analyst*, a financial-research journal (see chart 2). There are important differences between then and now. Debt was lower at the start of the Depression, at 164% of GDP. Mortgage debt was modest relative to home values, and prices were not notably bloated: they fell by 24% between 1929 and 1933, says Edward Pinto, a consultant, so were roughly flat in real terms. Debt burdens shot up because of deflation and shrinking output; nominal GDP fell by 46% between 1929 and 1933.

Debt burdens are high today mostly because so much was borrowed in the recent past. This began as a logical response to declining real interest rates, low inflation, rising asset prices and less frequent recessions, all of which made leverage less dangerous. But rising leverage eventually bred easy credit and overvalued homes.

Even without recession, falling home prices would have impaired enough mortgage debt to destabilise the financial system (see chart 3). Recession makes those dynamics more virulent; deflation could do similar damage. Broad price indices fell in late 2008. Granted, that was caused in part by a one-off fall in petrol costs; but America's core inflation rate, which excludes food and energy, has fallen from 2.5% in September to 1.8%. Goldman Sachs sees it falling to 0.25% in the next two years.



That is low enough to mean falling wages for many households and falling prices for many firms. More widespread and deeper deflation would mean that property prices would have to fall even further to restore equilibrium with household incomes, creating another round of delinquencies, defaults and foreclosures.

What is the solution? Fisher wrote that it was "always economically possible to stop or prevent such a depression simply by reflating the price level up to the average level at which outstanding debts were contracted." Alas, reflation is not so simple. Although stabilising nominal home prices would help short-circuit the debt-deflation dynamics now under way, any effort to maintain them at unrealistically high levels (where they still are in many cities) is likely to fail. Higher inflation could help bring down real home prices while allowing nominal home prices to stabilise, and reduce real debt burdens. But creating inflation is easier said than done: it requires boosting aggregate demand enough to consume existing economic slack, through either monetary or fiscal policy.

Though the Fed does not expect deflation, last month it did say that "inflation could persist for a time below" optimal levels. It is mulling a formal inflation target which, by encouraging people to expect positive inflation, would make deflation less likely. But its practical tools for preventing deflation are limited. In December its short-term interest-rate target in effect hit zero. The Taylor rule, a popular rule of thumb, suggests it should be six percentage points below. The Fed is now trying to push down long-term interest rates by buying mortgage-backed and perhaps Treasury securities. With conventional monetary ammunition spent, fiscal policy has become more important.

In 2002 Mr Bernanke argued the government could ultimately always generate inflation by having the Fed finance large increases in government spending directly, by purchasing Treasury debt. Martin Barnes of the *Bank Credit Analyst* thinks this highly unlikely: "You'd have capital flight out of the dollar. The only way it works is if every country is doing it, or with capital controls."

Fisher died in 1947, a year after Keynes, and remains in his shadow. Mr Dimand notes that Fisher never pulled the many strands of his thought together into a grand synthesis as Keynes did in “The General Theory of Employment, Interest and Money”. More important, Keynes’s advocacy of aggressive fiscal policy overcame the limitations of Fisher’s purely monetary remedies for the Depression.

Yet Fisher’s insights remain vital. They have filtered, perhaps unconsciously, into the thinking of today’s policymakers. On February 8th Lawrence Summers, Mr Obama’s principal economic adviser, called for the rapid passage of a fiscal stimulus “to contain what is a very damaging and potentially deflationary spiral.” His advice bridges Fisher and Keynes.

America's banking crisis

Worse than Japan?

Feb 12th 2009 | WASHINGTON, DC
From The Economist print edition

Illustration by Claudio Munoz

Look carefully and the answer could be yes

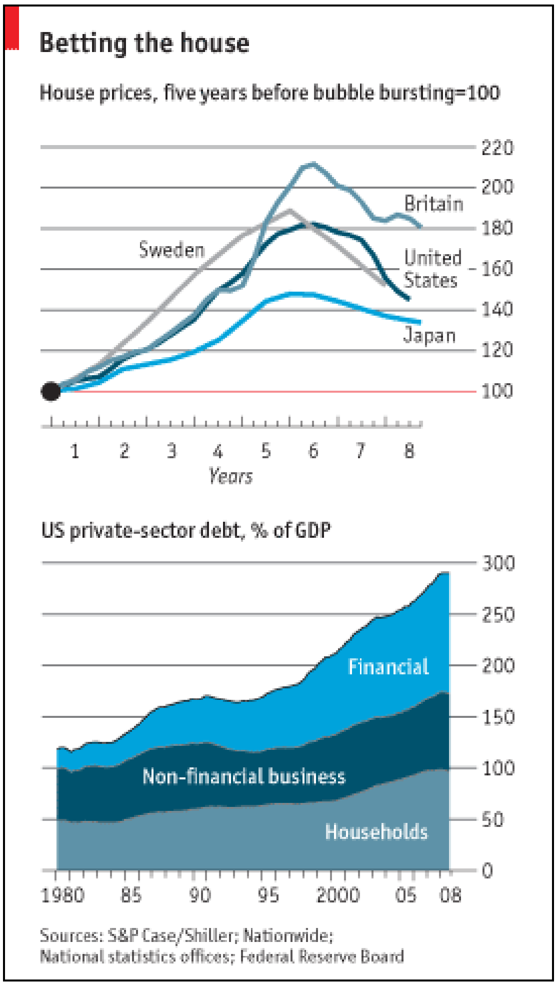
THERE is one consolation for the depressing instability of finance. History offers a rich array of banking crises from which policymakers can draw lessons—and against which today's rescue plans can be judged. According to an IMF database, there have been 124 "systemic" banking crises since 1970—episodes in which bad debts soared across the economy and much of the banking sector was insolvent.

Most of those were in the developing world. But the list also includes half a dozen rich-country crashes, from Japan's slump after its property bubble burst in the late 1980s, to the Nordic bank crises in the early 1990s. All involved deep recessions, required massive government intervention to clean up bust banks, and led to big increases in public debt as economies shrank while government spending soared. But the speed of recovery differed dramatically; Japan endured a decade of economic stagnation, whereas South Korea returned to growth within two years of its 1997 banking disaster.

Received wisdom holds that policy choices determined the pace of recovery. Sweden rebounded quickly because it acted fast: removing dud assets from banks' balance-sheets, recapitalising weak banks and nationalising where necessary. Japan stalled for a decade because it took years to recognise the scale of its mess. In his first presidential news conference on February 9th, Barack Obama pointed to Japan as an example of what not to do. Its "lost decade", he argued, was the consequence of "not act[ing] boldly or swiftly enough".

There is truth to that analysis. Japan's central bank took too long to fight deflation; its fiscal stimulus was cut off too quickly with an ill-judged tax increase in 1997; and it did not begin to clean up and recapitalise its banks until 1998, almost a decade after the bubble had burst. But the history of bank failures suggests that Japan's slump was not only the result of policy errors. Its problems were deeper-rooted than those in countries that recovered more quickly. Today's mess in America is as big as Japan's—and in some ways harder to fix.

Double bubble



This crisis, like most others in rich countries, emerged from a property bubble and a credit boom. The scale of the bubble—a doubling of house prices in five years—was about as big in America's ten largest cities as it was in Japan's metropolises. But nationwide, house prices rose further in America and Britain than they did in Japan (see first chart). So did commercial-property prices. In absolute terms, the credit boom on top of the housing bubble was unparalleled. In America private-sector debt soared from $22 trillion in 2000 (or the equivalent of 222% of GDP) to $41 trillion (294% of GDP) in 2007 (see second chart).

Judged by standard measures of banking distress, such as the amount of non-performing loans, America's troubles are probably worse than those in any developed-country crash bar Japan's. According to the IMF, non-performing loans in Sweden reached 13% of GDP at the peak of the crisis. In Japan they hit 35% of GDP. A recent estimate by Goldman Sachs suggests that American banks held some $5.7 trillion-worth of loans in "troubled" categories, such as subprime mortgages and commercial property. That is equivalent to almost 40% of GDP.

As the world's biggest debtor, America headed into this bust in a very different position from Japan, a creditor nation rich in domestic savings. Nonetheless the macroeconomic trends in America look more like those that existed in Japan than other crisis-hit countries. Most big banking failures, from Sweden's to South Korea's, were created or worsened by a currency crash. Tumbling exchange rates raised the real burden of foreign-currency loans, forced policymakers to keep interest rates high and pushed up the fiscal costs of bank rescues. (Because of the rupiah's collapse, for instance, the clean up of Indonesia's failed banks in 1998 cost more than 50% of GDP.) But, by boosting exports, a weaker currency also offered a route to recovery. In Japan, by contrast, the yen stayed strong as the economy slumped, deflation set in and the banking problems grew.

In some ways America's macroeconomic environment is even trickier than Japan's. America may have a big current-account deficit, but the dollar has strengthened in recent months. America's reliance on foreign funding means the risk of a currency crash cannot be ruled out, however. That, in turn, places constraints on the pace at which policymakers can pile up public debt. And even if the dollar were to tumble, the global nature of the recession might mean it would yield few benefits.

That is a big change. The most concentrated recent episode of systemic banking crises was the Asian financial crash in the late 1990s. The regional downturn was dramatic as firms slashed investment and

paid back debt. But buoyed by strong demand in the rest of the world, particularly America, these countries' exports soared, allowing a quick recovery. Even Japan eventually built its economic recovery on the back of booming exports. Today demand is falling rapidly across the globe and most big developed economies face simultaneous banking crises. With demand weak everywhere, the familiar route to recovery is blocked.

Beyond the banks

Administratively, today's crisis is far more complex than it was in countries where the clean-ups are presently being praised. In Sweden's highly concentrated banking system, one firm—Nordbanken—accounted for a quarter of all loans. The government dealt with a big part of the problem by taking over two banks. America's finance industry is more diffuse. Even after a wave of government-induced consolidation, there are at least a dozen systemically important commercial banks.

More important, Sweden's much-praised bad banks, into which the government shovelled troubled loans, dealt with straightforward credit backed by clear collateral. Even then the success was unusual. According to the IMF, asset-management companies were set up in 60% of banking crises, but were generally "ineffective". That seems more likely today when the complexities of securitisation have left "toxic assets" that range from pools of car loans to fiendishly complex collateralised-debt obligations, which are much harder to unravel, value and manage.

What is worse, today's bust is not just about banking. America faces twin financial crashes (as, to a lesser degree, do other Anglo-Saxon countries): one in the regulated banking sector and a simultaneous collapse of the "shadow banking system", the universe of hedge funds and investment banks responsible for much of the recent securitisation boom as well as for the sharp rise in financial leverage.

As a result, standard measures of banking distress, such as the level of non-performing loans, understate the contractionary pressure. So far most of the credit collapse in America has come from the demise of securitisation. In 2007, for instance, $668 billion of non-traditional mortgages were securitised. Last year that figure dropped to $40 billion. Rapid deleveraging outside traditional banks also means that cleaning up banks' balance-sheets may not break the spiral that is driving down asset prices and stalling financial markets. As the lower chart shows, financial-sector debt was the fastest-growing component of private-sector debt in recent years. Many of those excesses are being unwound at warp speed.

Illustration by Claudio Munoz

A final difference between today's bust and most other big banking crises is the importance of household debt. Historically, serious banking busts have mainly involved overborrowing by firms. In Japan, for instance, corporate borrowing soared in the 1980s against the collateral of rising share and property prices.

Today, however, household profligacy, which underpins much of the other debt, has been the problem. After the dotcom bust, American firms held back. Virtually all the rise in non-financial debt since 2000 was among households, as Americans tapped into the rising equity in their homes. Although troubled business

debts, such as commercial property, are rising, households are the worst hit.

That has important implications. Household balance-sheets are more difficult to restructure than corporate ones, which involve far fewer people. Politically, the process raises questions of fairness. How far, for instance, should taxpayers bail out reckless homeowners who bought mortgages they could not afford? On the other hand, the economic dislocation from unwinding a household-debt binge may be less disruptive than restructuring swathes of firms. As Anil Kashyap of the University of Chicago points out, one reason Japan was so loth to acknowledge the depths of its banking problems was the knowledge that a banking clean-up would require a large-scale restructuring of Japanese firms which, in turn, would throw many people out of work. Restructuring household debts may be political dynamite, but it would not require a wholesale remaking of corporate America.

Nonetheless, the rebuilding of American households' balance-sheets is likely to force a reliance on government demand that is bigger and longer-lasting than many now imagine. In the aftermath of Japan's bubble, firms spent more than a decade paying down debt and rebuilding their balance-sheets. This sharp rise in corporate saving was countered by a drop in the savings rate of Japanese households and, most importantly, by a huge—and persistent—increase in budget deficits.

A similar dynamic will surely play out in America's over-indebted households. With their assets worth less and credit tight, people will be forced to save much more than they used to. The household saving rate has risen to 3.6% of disposable income after being negative in 2007. For much of the post-war period it was around 8%, and in the short-term it could easily exceed that. But, whereas dis-saving by Japanese households countered the corporate balance-sheet adjustment, American firms are unlikely to invest more while consumers are in a funk. Propping up demand may therefore require more persistent, and sustained, budget deficits than in Japan.

Add all this together and the ease with which American policymakers dismiss Japan's experience is probably misplaced. Japan's outcome—a decade in which growth averaged 1% a year and gross government debt rose by 80 percentage points of GDP—was not one to be proud of. But given the magnitude of today's mess, it may soon seem not that bad after all.

America's bank bail-out

Dashed expectations

Feb 12th 2009 | NEW YORK
From The Economist print edition

Tim Geithner hopes to restore stability to the banking system by luring in private investors. The devil will be in the missing detail

"WE'RE going to have to hold out a Band-Aid a little bit…and just be clear about some of the losses," Barack Obama said of America's sickly banks this week. As much as $2.5 trillion buys more than a little bit of sticking plaster, one would hope. That is the sum of fresh money that Tim Geithner, Mr Obama's treasury secretary (pictured below), hopes to channel into the financial system through his overhaul of the Troubled Asset Relief Programme (TARP), in large part by using public funds to coax private investment.

AFP

The man with a "plan"

Across the world, there is agreement on the need for a more comprehensive response to the crisis. European ministers this week discussed setting up "bad banks" to buy illiquid assets. Mr Geithner, meanwhile, is keen to distance himself from the ad hoc approach of his predecessor, though his implicit swipes at Hank Paulson, with whom he worked closely on bail-outs, will strike some as unbecoming.

A pity, then, that his plan was more a statement of intent than a concrete proposal, lacking crucial details when, as he himself acknowledged, public distrust and anger over previous government efforts is running high. Markets reacted badly, with shares down (particularly in big banks) and safe assets, such as gold, rallying. Economists, even those supportive of Mr Obama, were underwhelmed. "Maybe it's a Trojan horse that smuggles the right policy into place," mused Paul Krugman, grimly, at Princeton.

Most disappointment was directed at the sketchy plan to tackle banks' toxic assets, such as mortgage-backed securities and leveraged loans. At a late stage Mr Geithner rejected the idea of a government-run bad bank (as well as blanket guarantees for noxious assets), put off by the high upfront cost and the problems it would have valuing the debt. He now hopes to amass $1 trillion of buying power by drawing in investors, such as private-equity groups, whose inclusion would stretch the government's money further and bring more discipline to pricing.

Fine, but Mr Geithner still has a yawning gap to bridge between banks, which do not want to sell at depressed prices because of losses they would have to recognise, and potential buyers, who need to be sure of healthy returns. It was this that put paid to both the original TARP and Mr Paulson's efforts to

rescue structured-investment vehicles. Distressed-debt investors, such as Blackstone and BlackRock, are interested but want more information. To be sure of attracting them, the government might need to provide a combination of cheap loans and a guaranteed floor on losses. But even then, the mooted public-private partnership may not be big enough. Barclays Capital counts $2 trillion-3 trillion of troubled assets in America, excluding prime mortgages, which are souring fast.

The plan also falls short in its treatment of the root cause of the crisis: housing. The $50 billion programme to curb foreclosures is modest and short on detail. It is not clear, for instance, if it will include incentives for mortgage lenders and servicers to write down borrowers' principal, which may be the only way to stop the rot—though more details are expected in coming weeks. Mr Paulson fought to keep foreclosure mitigation out of the TARP, preferring to focus on strengthening financial firms. That is no longer an option. Mortgage relief is "the pound of flesh demanded by an angry public" for the cost of the bank bail-out, says Stephen Stanley of RBS Greenwich Capital.

A more promising feature is the fivefold expansion of a $200 billion Federal Reserve lending facility for buyers of securities backed by consumer loans, the market for which collapsed last year. Reviving important non-bank funding sources, such as securitisation, is essential, even if its huge expansion in the credit boom led to the mispricing of risk.

The hope, however peculiar it sounds, is that, just as leverage got finance into this mess, it can help get finance out again. The facility will deploy $9 of Fed loans for every dollar of TARP funds—the central bank can in effect print money at will. Encouragingly, hedge funds are itching to take advantage of the attractive financing terms. But dealing directly with them, and ensuring they do not game the system, will take regulators into uncharted territory.

It is banks that matter most, however, and some of the biggest are suspected of being insolvent or close to it. That poses a dilemma for Mr Geithner: he will not let the giants fail, yet he is determined to avoid nationalising them. (Indeed, the plan was apparently rushed out, perhaps before it was ready, in part to put such talk to rest.) He envisages a new round of capital injections, with the government taking preferred shares convertible into the common variety, as needed, to bolster banks' cushions against losses.

His plan also calls for banks with assets of more than $100 billion to undergo "stress tests" to determine their ability to withstand a severe and lengthy recession. The results will be ugly for some, given how slow they have been to build reserves and acknowledge dud loans.

Congress and the public are in no mood to keep ploughing capital into ailing giants—Citigroup and Bank of America have already taken $45 billion apiece, plus extensive asset insurance—without more drastic consequences. Nationalisation may be unAmerican, but the mood is turning even more sharply against the nationalisation of losses while profits largely remain in private hands.

Bankers complain that they are already in the grip of government. Citi can barely move without first getting Treasury or Fed approval. Following executive-pay curbs announced on February 4th, the new plan restricts dividends to a penny, forces banks to step up mortgage modifications and bans acquisitions of healthy competitors until the taxpayer is repaid.

It might have been even harsher, had Mr Geithner not fought off calls by White House aides who wanted to, for instance, set firm lending targets. Instead, banks will have to submit plans explaining how they intend to "preserve or generate new lending". This should give them wiggle room, which may be no bad thing given the disastrous record of forced lending.

The shackles will surely tighten, however, if more money is needed from Congress once the $700 billion TARP (now renamed the Financial Stability Plan) is exhausted. That seems all but certain, given the speed with which the industry is deteriorating. The most pessimistic forecasts now put the number of American banks that could fold over the next five years at 1,000, six times more than are presently on the regulatory problem list.

All the more important, then, to get this plan right. "This is the last bite of the apple before bail-out fatigue overwhelms us," says one banker. But there are many blanks to be filled in. The biggest challenge will be to crack the pricing puzzle and get impaired loans moving in a way that works for banks, vulture-investors and the taxpayer. So far in this crisis, policymaking has been "behind the curve", Mr Geithner acknowledged this week. Yet again he failed to get ahead of it.

Buttonwood

A lament for savers

Feb 12th 2009
From The Economist print edition

Prudence gets penalised

Illustration by S. Kambayashi

BORROWERS get bailed out. Run your bank into the ground and the taxpayer will lend it money. Buy a house you cannot afford and the central bank will cut interest rates to ease your burden.

Meanwhile those who have lived within their means and put money aside for the proverbial rainy day, have seen interest rates slashed to 2% in the euro zone, 1% in Britain and virtually nothing in America. No one offers to help them out, even though saving is needed to allow business investment which, in turn, generates growth. Asians, told off in the 1990s for their current-account deficits, now get lectured for saving too much.

This is quite a different paradox of thrift from the usual one. In theory, everybody regards thrift as a virtue. In practice, they treat it as a vice.

Of course, politicians and economists will argue that they are only talking about the short run. They need people to spend to lift the economy out of recession. As John Maynard Keynes remarked: "Whenever you save five shillings, you put a man out of work for the day."

One could argue that savers should do well in the event of outright deflation. Nominal interest rates may have fallen sharply. But they cannot fall below zero. So in a world of falling prices, real rates will be high.

Nevertheless, savers are far from content. Those who have built diversified portfolios (another hallmark of prudence) will have suffered losses in equities, property and corporate bonds. Even those who have been clever enough to keep their money in cash have had to fret about the security of banks and money-market funds.

In any case, the community of savers is a diverse one. Take the many elderly people who depend on their savings for retirement income. When interest rates fall as quickly as they have in recent months, their income falls, and they will be forced to spend less.

The retired do not have the option of making up lost income. They are too old to work, or companies may not consider them employable. They could take more risk by moving into corporate bonds or equities. But that strategy incurs the danger of a permanent loss of capital.

In many countries the system is biased against the saver. Interest income is usually taxable, whereas some countries allow mortgage payments to be tax deductible. In Britain state benefits are means-tested. An elderly person with more than £22,250 ($32,000) in savings, hardly a golden nest-egg, has to pay the full cost of nursing-home care, which can easily exceed £40,000 a year. Those Britons who have saved money in the form of a personal pension must turn the bulk of their pot into an annuity by age 75; if they drop dead at 76, the insurance company keeps the lot.

Another group of savers are those who are planning for retirement (or other events such as children's weddings or education fees). They have to make a complex series of calculations. What is their future liability, and what return can they expect?

Recent events will make such people want to save more, not less. Say you wished to buy a retirement income of $25,000 a year by investing in ten-year American Treasury bonds. In the summer of 2007, you would have needed a sum of $476,000 to get that result. But bond yields have plunged since then. Generating the same income would now require a sum of $833,000. And, with yields as low as they are,

you would have to put more aside from your income to reach any targeted level of capital.

In theory, of course, long-term returns from risky assets like equities should be much higher now than they were 18 months ago, because of the fall in valuations. But few savers will be brave enough to make that bet.

Indeed, those saving for retirement have another problem to worry about. A much-discussed trend of the past ten years has been for employers to switch from final-salary to money-purchase pension schemes, transferring the investment risk to the employee. Less well advertised is the fact that the shift has allowed employers to cut the overall level of their contributions, and the financial crisis has prompted some to impose a moratorium on payments.

Rationally, therefore, many workers should be saving more for their retirement right now. And that is before they consider building up a cash cushion against the risk of losing their job, or rebuilding their wealth to offset falling house prices.

Such people will be prudently preparing for the future, with the aim of not being a burden on the state. And they will get no thanks for it whatsoever.

Santander and BBVA

The Spanish derby

Feb 12th 2009 | MADRID
From The Economist print edition

A bitter rivalry exists between two credit-crunch survivors

FRANCISCO GONZÁLEZ insists the Spanish bank he chairs, BBVA, is very different from its larger rival, Santander. The comment came moments after Santander stole his thunder by announcing impressive headline results—a week early—in the middle of Mr González's own presentation of the bank's 2008 accounts.

Santander says a market regulator forced it to make the disclosure, but Mr González was unimpressed. Santander, led by its chairman, Emilio Botín, reported an impressive €8.9 billion ($13.06 billion) net profit in 2008, and is paying more than half of that figure to shareholders in cash. BBVA, meanwhile, is paying its 2008 dividend partly in shares, and prudently plans to cut the payout ratio for 2009.

AFP

Which is BBVA, which is Santander?

Rivalries aside, the banks created a combined €14.3 billion in net profit in a year when many of their banking peers around the world were on their knees. This was not a coincidence. Both banks focus mostly on retail banking, and avoided investments in toxic off-balance-sheet exposures at the behest of the Bank of Spain.

For years, the two banks closely mimicked each other, expanding in Spain, which is still the main source of profits, and in Latin America. But Mr González is right: the banks are increasingly different. This is, in part, because of their chairmen.

Mr Botín, a fourth-generation banker, has a tight grip over his company and has keenly pursued deals, such as the purchase of Britain's Abbey National, a mortgage lender, in 2004. Through a smart bit of asset flipping, it was the only bank that profited from the ill-fated takeover of ABN Amro, a Dutch bank, in 2007. It has since bought Alliance & Leicester and part of Bradford & Bingley, two British mortgage banks, as well as the 76% of America's Sovereign Bancorp it did not already own. There have been sobering questions about Santander's management, however, after it lost €2.3 billion on behalf of its clients in Bernard Madoff's alleged $50 billion Ponzi scheme. It has offered a settlement in a bid to repair its reputation but is being challenged in American courts.

Meanwhile, BBVA's managers do not own significant stakes in the bank and consider themselves to have a more conservative culture. Mr González, who has earned the nickname of "Mr No", was taken aback recently when Santander tapped the market for €7.2 billion days after denying the need to bolster its levels of capital. BBVA rushed to deny it too needed more capital.

Though both banks know 2009 is going to be difficult, Mr Botín insists that profits and the dividend will stay steady. Both have a thick layer of provisions to draw on. Credit quality, however, is deteriorating fast. Santander has exposure to two of the most heated economies in Europe—Spain and Britain—and Brazil, where it has big operations, is slowing sharply. Its level of non-performing loans is low, but is flattered by Santander's purchase of property financed by its own loans. It buys the properties before the loans go bad, and expects to sell them when the market recovers. Here, Santander has bought more than BBVA—€3.8 billion in 2008, versus €629m for BBVA.

BBVA, meanwhile, has a big exposure to Mexico, an economy also entering recession. It has lost €300m by lending to clients invested with Mr Madoff. Its core, tier-one capital, at 6.2%, looks low, but the reduced dividend may help shore it up.

For all the rivalry, both banks admit the competition keeps them on their toes. It also benefits the markets where they compete. As one Santander client put it, having two top banks in Spain is almost as good as housing two of the world's best football teams, Barcelona and Real Madrid.

Japan's brokerages

Anything but cordial

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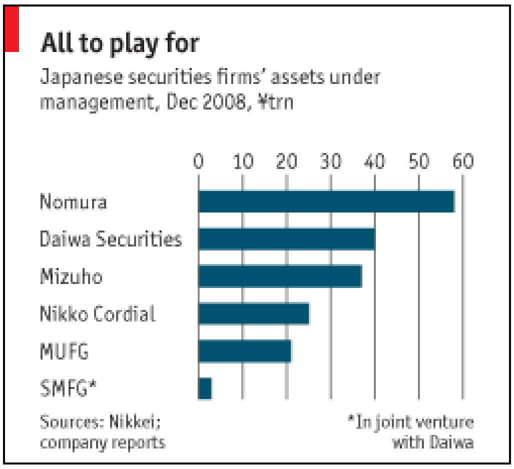
From The Economist print edition

More competition is emerging for Japan's downtrodden brokers

IT IS a harsh winter in Nihonbashi, Japan's old financial district. Shares of Nomura, the biggest broker, hit their lowest level in more than 25 years on February 9th, after it said it would raise up to ¥300 billion ($3.3 billion) by issuing new common shares to shore up its capital—diluting shareholders by roughly 30%. The amount does not even cover its last quarterly loss. Daiwa, too, has lost money and raised capital. And Nikko Cordial, acquired by Citigroup last year for $16 billion, went on the auction block on February 12th as its stricken foster parent hunts for cash.

For all the pain, there is no shortage of ambition in Japan's brokerage business. The three megabanks are keen to muscle in, benefiting from a law last year that lowers the regulatory firewall between banks and their securities arms. Each has its eye on Nikko Cordial, the third-biggest securities house, which would put its owner within striking distance of Nomura, the largest (see chart). Besides the cost, though, there are other impediments.



One of the giants, Sumitomo Mitsui Financial Group, already has tight ties with Daiwa, which it would need to unwind. Meanwhile, Mitsubishi UFJ Financial Group, which last autumn took a 20% stake in Morgan Stanley, is in talks to integrate both groups' Japanese securities units. Combining MUFG's retail operation with Morgan Stanley's wholesale business would create the country's third-largest broker, ahead of Nikko Cordial. Mizuho is still struggling to combine the operations of the three huge banks from which it was cobbled together in 2002.

Nomura, which two decades ago was the world's largest securities house, has its sights overseas: it is said to be once again on a hiring binge in New York, having already snaffled Lehman Brothers in Europe and Asia in September. It is considering reforming its pay system to make it more akin to a Western investment bank. It hopes to dominate investment banking in Asia, and be a force to be reckoned with around the globe.

Perversely, the terrible state of the Japanese economy may make the business a bit more attractive. Brokerage limps but investment banking leaps: only in times of crisis do Japanese companies restructure and sell businesses. And Japanese firms are taking advantage of their solid cash position and a strong yen to make overseas acquisitions; last year they spent around $75 billion abroad, a record. The trick, elusive so far, is turning these flickers of opportunity into solid profit.

Private equity

Return to earth

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Buy-outs are souring at an alarming rate as banks turn away

THE Super Return conference draws its name and much of its mythology from happier times in the world of private equity. In previous years partners in the largest American buy-out firms are said to have raced their private jets across the Atlantic. At this year's conference in Berlin there were few signs of such extravagance—just one lonely Bentley was parked out front. Unlike the years in which the assembled buy-out barons crowed about their mind-boggling profits, this year they were warning that few should expect any return at all.

Yet a more ominous pall hangs over the industry, and the firms they have bought, than the prospect of investors losing some of their money. A large number of companies it bought in recent years look as if they are about to go to the wall.

Many will fail for the obvious reasons; too much was paid for them amid rosy forecasts as to how much debt they could carry. Heino Meerkatt of the Boston Consulting Group reckons that as many as half of the companies owned by private-equity firms may default on their debt within the next three years, leading to a wave of insolvencies, and losses of as much as $300 billion washing through the financial system (some $50 billion-80 billion of which may be borne by the banks).

Yet it is not necessarily the most indebted companies, or those bought at the height of the boom, that will go bust first. The most leveraged basket cases are often left to limp along, mainly because they are worth so little that banks do not expect to recover much from liquidating them. And deals financed when bubble mentality was at its most frenzied often had so-called "covenant-light" loan agreements, which gave their bankers few rights to demand repayment. Many of these companies may go bust in time, but until then they too can keep drawing breath.

Worryingly, however, a large number of profitable companies that are still paying down their loans may go bust through no fault of their own. Simon Walker of the BVCA, an industry group, frets that British banks in particular are forcing sound firms into early liquidation over minor breaches of their loan agreements in order to reduce the size of their loan books.

In many cases banks may simply be reacting swiftly when companies trigger genuine tripwires, such as a fall in profit to below a specified level, which are designed to alert them to the possibility of trouble ahead. But the worry is that some banks, keen to rein in borrowing, are pouncing on purely technical breaches of banking covenants that have little to do with the underlying creditworthiness of the companies they have lent money to.

Gallingly, many firms are in a catch-22 caused by their banks. Accountants say they cannot sign off on portfolio companies as going concerns unless they have letters from banks reassuring them that credit facilities such as overdrafts will be renewed. Banks, however, are proving reluctant to commit to lending given their own funding constraints. Yet if companies fail to get their accounts signed off by their auditors (or if they are qualified in any way) they may be in breach of their covenants.

Amid such gloom, private-equity firms have given up hope of earning super returns over the short term and most just want to nurse their companies through the downturn. If the banks thwarted that needlessly it would be a shame—not to mention self-defeating.

Temasek

Chip off the new block

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Singapore recruits a heavy hitter to run one of its sovereign-wealth funds

Reuters

Mr Goodyear, first among expats

“THIS is a win-win, home-run opportunity.” With that technocratic mouthful, Charles “Chip” Goodyear demonstrated his credentials for his new job as chief executive of Temasek, one of Singapore’s two sovereign-wealth funds. Mr Goodyear, the American former boss of BHP Billiton, a mining giant, will in October replace Ho Ching, who has been in place since 2004 and is the wife of the prime minister. A third of Temasek’s staff are expatriates but since its creation in 1974, it has never been led by a foreigner.

The sceptic’s explanation for this unexpected change might be that Temasek has lost a lot of money. Four days after Mr Goodyear’s appointment the government said Temasek’s assets had fallen from S$185 billion ($134 billion) at the end of last March, to S$127 billion ($84 billion) at the end of November. There have been big, poorly timed equity injections into Barclays and Merrill Lynch. Indeed, adding in the stakes bought in UBS and Citigroup by Singapore’s other sovereign fund, GIC, the city-state has bet the equivalent of 13% of its GDP on bailing out four struggling Western banks: by any standard, a mistake.

Yet Temasek’s overall performance has been merely mediocre rather than abysmal—the 37% drop in dollar terms over eight months is exactly in line with the MSCI world share index. Temasek’s three biggest investments, in China Construction Bank, Standard Chartered and Bank of China, have performed relatively well. The fund’s balance-sheet remains solid and the share of Singaporean assets has shrunk to a third, from half in early 2005. Mr Goodyear says he began negotiations 15 months ago, giving credence to Temasek’s claim that his appointment is not a knee-jerk reaction to a few dodgy investments.

That being so what does Mr Goodyear bring? He won plaudits for his stint at BHP Billiton and has a deep knowledge of commodities, in which Temasek is underweight. Decades of financial experience help too—“the common denominator of business is numbers,” he says. But most important, Mr Goodyear is the kind of A-list executive who will help persuade the countries receiving potential investment that Temasek really is independent of the government. That Mr Goodyear’s appointment was a surprise goes a long way to explaining why it makes sense.

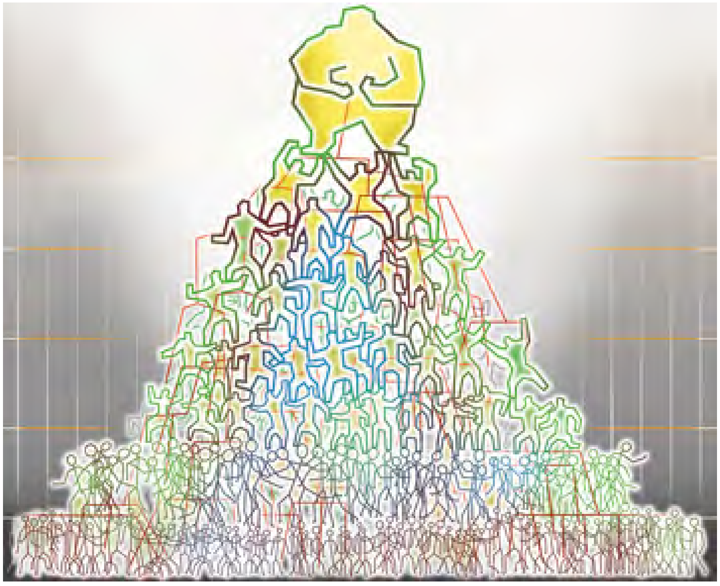
Economics focus

Pharoah capitalism

Feb 12th 2009
From The Economist print edition

The costs and benefits of “pyramid” business groups

Illustration by Jac Depczyk



LIKE a blot on corporate India’s copybook, the Satyam scandal is still spreading. Two auditors from PricewaterhouseCoopers are in police custody, where they are trying to explain why they signed off on the outsourcing company’s cooked books. The chief minister of Satyam’s home state is trading furious accusations of negligence and worse with his predecessor. And on February 6th the government revealed that its serious fraud office is investigating no fewer than 325 companies wrapped up in the scam perpetrated by Satyam’s founder, B. Ramalinga Raju, and at least one of his brothers.

In India, as in many emerging markets, companies rarely stand or fall alone. Tarun Khanna of Harvard Business School and Yishay Yafeh of the Hebrew University of Jerusalem report* that a third of Indian firms in the 1990s belonged to wider business groups, controlled by wealthy families or corporate “promoters”. These clubable firms were typically 4.4 times bigger than stand-alone companies.

Elsewhere in Asia, business groups are equally prevalent. In Hong Kong 15 families control corporate assets worth 84% of GDP, according to a 2000 article** by Stijn Claessens, now at the University of Amsterdam, Simeon Djankov of the World Bank and Larry Lang, now at the Chinese University of Hong Kong. In Malaysia the figure is 76%.

These families exercise far more control than they pay for; their corporate reach exceeds their financial stake. This is sometimes because they hold a privileged class of shares that carry more votes than common equity. Sometimes they appoint a loyal relative as chief executive. But the most ambitious strategy for projecting control is to build a corporate “pyramid”.

The geometry works like this: the family holds a controlling stake (say 51%) in a company at the top of the pyramid. This firm then holds similar stakes in a second tier of companies, which will in turn maintain stakes in a third tier. In this way, the family controls the entire pyramid from top to bottom, even though its financial commitment to the second tier is only 26% (51% of 51%) and its stake in the third tier is only about 13%.

Pyramids solve what Yoshisuke Aikawa, the founder of the Nissan group in pre-war Japan, once called the “capitalist’s quandary”: how to raise money from outsiders without ceding control. Students of corporate governance view them less benignly. To them, pyramids combine the twin dangers of entrenched

management and diffuse ownership.

In a closely held company, the manager is hard to oust because he owns most of the firm. But at least he will want to make a good return on equity, given that he owns most of it. In widely held companies, managers are easier to replace—they are hired help. But, by the same token, they have less skin in the game.

Pyramids combine the “worst of both worlds”, point out Randall Morck# of the University of Alberta and Daniel Wolfenzon and Bernard Yeung of New York University. They are tightly controlled by families, who have only a paltry stake in the companies at their base. When this gap between control and ownership grows too large, the pharaohs have an incentive to divert resources from companies at the bottom of the pyramid (where they might claim only 13 cents on the dollar) to the top (where their claim is 51 cents).

In a study of eight East Asian economies (Hong Kong, Indonesia, South Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand), Mr Claessens and his co-authors show that a family’s “control rights” often exceed their equity claim by a wide margin. When this gap grows to 35 percentage points or more, the market value of firms drops to only 80% of their book value.

Satyam may not have been part of a pyramid, but it is a good example of control exceeding ownership. The Raju family’s stake had dwindled to 5% or less on the eve of Mr Raju’s January 7th confession. What started out as a small family firm had become a widely held corporation, to which 218,000 shareholders had entrusted their money. But as subsequent revelations have made clear, it was still firmly in Mr Raju’s grip. Its market value has since plummeted. No one knows its book value.

Pharaonic sacrifices

If pyramids are such a threat to minority shareholders, Mr Khanna asks, why does anybody ever buy shares in them? One answer is that the danger is reflected in the price small investors are willing to pay for their shares. In some countries, the cost per share for a minority stake is 40% lower than the share price for a controlling block.

Another answer is that the pyramid can be a source of stability as well as exploitation. Mr Khanna shows that firms in heavily diversified Indian business groups outperform their free-standing rivals. Perhaps firms in a pyramid can prop each other up, offering “mutual insurance” that may be hard to buy on the market.

In a recent working paper, Yan-Leung Cheung@ of the City University of Hong Kong and his co-authors look at over 290 related-party transactions between listed Chinese firms and their controlling shareholders. They found that 132 of these transactions ended up benefiting minority shareholders. In August 2001, for example, Luoyang Glass, which is listed on the Shanghai stock exchange, received a $28m loan from its unlisted state-owned godfather. In the days after the announcement, its shares beat the market by 8.1%.

In his confession, Mr Raju said he had personally raised 12.3 billion rupees ($250m) in loans to help keep Satyam afloat. He may even be telling the truth. But pharaohs like to be buried in their pyramids, not for them. According to the *Indian Express*, a newspaper, he is now asking Satyam for the money back.

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Animal behaviour

Decisions, decisions

Feb 13th 2009
From The Economist print edition

What people can learn from how social animals make collective decisions

Mary Evans

DICTATORS and authoritarians will disagree, but democracies work better. It has long been held that decisions made collectively by large groups of people are more likely to turn out to be accurate than decisions made by individuals. The idea goes back to the "jury theorem" of Nicolas de Condorcet, an 18th-century French philosopher who was one of the first to apply mathematics to the social sciences. Now it is becoming clear that group decisions are also extremely valuable for the success of social animals, such as ants, bees, birds and dolphins. And those animals may have a thing or two to teach people about collective decision-making.

Animals that live in groups make two sorts of choices: consensus decisions in which the group makes a single collective choice, as when house-hunting rock ants decide where to settle; and combined decisions, such as the allocation of jobs among worker bees.

Condorcet's theory describes consensus decisions, outlining how democratic decisions tend to outperform dictatorial ones. If each member of a jury has only partial information, the majority decision is more likely to be correct than a decision arrived at by an individual juror. Moreover, the probability of a correct decision increases with the size of the jury. But things become more complicated when information is shared before a vote is taken. People then have to evaluate the information before making a collective decision. This is what bees do, and they do it rather well, according to Christian List of the London School of Economics, who has studied group decision-making in humans and animals along with Larissa Conradt of the University of Sussex, in England.

The runaway queen

In a study reported in a special issue of the *Philosophical Transactions of the Royal Society B*, researchers led by Dr List looked at colonies of honeybees (*Apis mellifera*), which in late spring or early summer divide once they reach a certain size. The queen goes off with about two-thirds of the worker bees to live

in a new home leaving a daughter queen in the nest with the remaining worker bees. Among the bees that depart are scouts that search for the new nest site and report back using a waggle dance to advertise suitable locations. The longer the dance, the better the site. After a while, other scouts start to visit the sites advertised by their compatriots and, on their return, also perform more waggle dances. The process eventually leads to a consensus on the best site and the swarm migrates. The decision is remarkably reliable, with the bees choosing the best site even when there are only small differences between two alternatives.

But exactly how do bees reach such a robust consensus? To find out, Dr List and his colleagues made a computer model of the decision-making process. By tinkering around with it they found that computerised bees that were very good at finding nesting sites but did not share their information dramatically slowed down the migration, leaving the swarm homeless and vulnerable. Conversely, computerised bees that blindly followed the waggle dances of others without first checking whether the site was, in fact, as advertised, led to a swift but mistaken decision. The researchers concluded that the ability of bees to identify quickly the best site depends on the interplay of bees' interdependence in communicating the whereabouts of the best site and their independence in confirming this information.

This is something members of the European Parliament should think about. In the same journal, Simon Hix, also of the London School of Economics, and his colleagues examined their voting and concluded that, as might be expected, it was along party-political lines even though the incentives to do so were far less than at national parliaments. Dr Hix and his colleagues reckon that European parliamentarians share the collection of information but, unlike the honeybees, they do not necessarily progress to investigating the issues for themselves before taking a vote.

There is danger in blindly following the party line, a danger that the honeybees seem to avoid. Condorcet's theory fails to consider whether there is an inbuilt bias among a group that comes together to consider a problem. This "groupthink" occurs when people copy one another. According to Dr List: "The swarm manages to block and prevent the kind of groupthink that can bedevil good decision making." Dr List adds that people demonstrate this kind of bad decision-making when investors pile into a stock and others follow, creating a bubble for which there is no good reason.

Another form of groupthink occurs when people are either isolated from crucial sources of information or dominated by other members of the group, some of whom may have malevolent intent. This too has now been demonstrated in animals. José Halloy of the Free University of Brussels used robotic cockroaches to subvert the behaviour of living cockroaches and control their decision-making process. In his experiment, reported in an earlier issue of *Science*, the artificial bugs were introduced to the real ones and soon became sufficiently socially integrated that they were perceived as equals. By manipulating the robots, which were in the minority, he was able to persuade the cockroaches to choose an inappropriate shelter—even one which they had rejected before being infiltrated by machines. Could this form the basis of a new way of catching them?

The way animals make collective decisions can be complex. Nigel Franks of the University of Bristol, in England, and his colleagues studied how a species of ants called *Temnothorax albipennis* establish a new nest. In the Royal Society journal they report how the insects mitigate the disadvantages of making a swift choice. If the ants' existing nest becomes threatened, the insects send out scouts to seek a new one. How quickly they accomplish this transfer depends not only on how soon the ants agree on the best available site but also on how quickly they can migrate there. When a suitable place is identified, the scouts begin to lead other scouts, which had remained behind to guard the old nest, to the new site. The problem is that if the decision is reached rapidly, as it might have to be in an emergency, then relatively few scouts know the route. It would then take much longer to train all the scouts needed to achieve the transfer, which involves carrying the queen, the workers and the brood to the new nest.

Dr Franks and his colleagues identified a type of behaviour called "reverse tandem runs" that makes the process more efficient. During the carrying phase of migration, the scouts lead other scouts back along the quickest route to the old nest so that more scouts become familiar with the route. Thus the dynamics of collective decision-making are closely entwined with the implementation of these decisions. How this might pertain to choices that people might make is, as yet, unclear. But it does indicate the importance of recruiting active leaders to a cause because, as the ants and bees have discovered, the most important thing about collective decision-making is to get others to follow.

Greenhouse gases

Accounting from above

Feb 12th 2009
From The Economist print edition

Two new satellites will monitor carbon-dioxide emissions

Reuters

SOMETIMES it is worth looking at the big picture. That is the idea behind monitoring greenhouse gases from space. In January the Japanese space agency, JAXA, launched *Ibuki*, the first satellite dedicated to monitoring carbon dioxide and methane. Later this month the American space agency, NASA, is due to launch the Orbiting Carbon Observatory (OCO), which is also designed to monitor carbon dioxide.

The new satellites will work as carbon accountants by keeping a close eye on how the Earth breathes and returning regular audits. *Ibuki*, which means “breath” in Japanese, orbits the Earth approximately every 100 minutes at an average altitude of 667km. It will gather data from 56,000 points around the globe with two detectors. One is a spectrometer that measures sunlight reflected from the Earth’s surface. Both carbon dioxide and methane absorb energy from sunlight and both leave a unique signature that can be measured to detect changes in intensity. JAXA says *Ibuki* can detect carbon-dioxide changes of around one part per million, which is akin to detecting the change in salinity produced by four drops of salt water in a 200-litre bathtub of water. The second detector takes readings of clouds and other aerosols in the Earth’s atmosphere that can reflect or absorb radiation.

OCO will similarly study carbon dioxide and also oxygen signatures in reflected sunlight. It will fly at an average altitude of 705km and orbit the Earth about every 99 minutes. Once launched, OCO will form part of a loose group of American satellites called the “A-train”. These carry instruments that complement one another in helping to provide a fuller picture of the Earth’s carbon and water.

The carbon cycle

With the additional data that the satellites provide, researchers hope finally to shed light on the Earth’s complicated carbon cycle. The concentration maps produced by *Ibuki* and OCO will help in understanding where carbon dioxide enters the atmosphere and where it gets absorbed. Today, most big man-made carbon-dioxide emitters, such as a large power station, are known about and their outputs are measured. But there are global phenomena, such as forest fires, where the carbon-dioxide contributions are not fully understood. There are also some ecosystems, such as the boreal forests of Canada and Siberia and the Amazon rainforest, which are huge absorbers of carbon dioxide, but which are changing rapidly because of temperature increases and deforestation.

Researchers think that the carbon cycle turns over about 330 billion tonnes of carbon dioxide each year. Oceans absorb about half this. Earth-based measurements suggest there is a large unaccounted-for surface “sink” of atmospheric carbon dioxide, but its location is fiercely debated. The reason for this is the paucity of data over the tropics, where many of world’s dense (and highly inaccessible) rainforests are situated. The satellites will be able to look in detail there.

Although these data will not be as accurate as those taken on the ground, what they lack in precision will be more than made up for in coverage. It is believed that atmospheric carbon-dioxide concentrations have increased from about 280 parts per million to around 370 parts per million since the start of the Industrial Revolution. How much of this is because of human action is still a matter of conjecture, but it is widely accepted to be significant.

Ibuki and OCO should provide a better idea of what happens to carbon dioxide once it is produced. Some researchers, such as Paul Palmer at the University of Edinburgh, in Scotland, think satellites could also monitor the effect of policies such as carbon trading to see if they can rein in emissions. The new birds really would then become carbon accountants.

Predators and prey

Hunting restrictions

Feb 12th 2009
From The Economist print edition

Controlling the size of predators

JOHN MUIR commented that every time he saw a grizzly bear the wilderness got bigger. Others faced with such an encounter might readily agree with the Scottish-born American naturalist who explored large parts of the western United States. Yet today's predators are smaller than those of the past, and the reason seems to have something to do with the speed of their prey.

Large predators gain tremendous benefits from being big. Killing other animals and protecting or stealing a carcass from others tend to be easier since their teeth and claws are larger. Handling struggling prey is safer as the larger predator has less trouble holding the prey firmly and preventing it from striking out at the hunter's vital organs. These attributes were even more important in the past since life was tougher for predators then (see article).

A new study, however, reveals that excessive size can interfere with predators' hunting. Daniel MacNulty of the University of Minnesota and his colleagues have found that for predators which need to run after their prey, being big can be more of a hindrance than a help.

Tracking the pack

Using a combination of radio-tags and direct observations, the researchers analysed 94 wolves as they hunted elk in Yellowstone National Park, Wyoming. They made a detailed record of their hunting and kills between 1995 and 2003. The weights of the individual wolves were estimated based upon models derived from body-mass measurements taken concurrently from 304 wolves, including 86 of the 94 wolves in the study. Weights ranged from 22 to 64kg.

The researchers report in the *Journal of Animal Ecology* that although on the whole big animals are indeed better at handling and killing prey, the largest wolves struggled in the chase. The odds of successful handling and killing improved by 7% for each 1kg increase on average. Up to 39kg each extra kilogram of body mass increased the success of a pursuit by 19%; but above that threshold each kilogram decreased the success by 1%.

Big animals did indeed have longer strides and ran faster, but only up to a point—39kg for the Yellowstone wolves. Beyond that, the strain of being large overcomes the benefits of a longer stride, says Dr MacNulty. This restricts the size of wolves, since becoming too large would ultimately leave them unable to hunt.

The researchers conclude that smaller carnivores would have had an advantage in environments with predominantly fast prey, and bigger ones where prey was slower and larger. As cave bears and wolves from a few million years ago were bigger than their descendants, they were probably quite a bit slower than they are today. Not that it would make the wilderness seem any smaller.

Carnivores' teeth

Tooth and claw

Feb 12th 2009
From The Economist print edition

The bite of a harsh past

ARTISTIC interpretations of prehistory rarely present landscapes that embody harmony and tranquillity. Far more often they depict harsh environments with erupting volcanoes, tempests and battles between predators and their prey. Now a study of broken teeth reveals that artistic licence has, at least for predator and prey, been rather accurate.

Blaire Van Valkenburgh, a palaeontologist at the University of California, Los Angeles, became curious about whether tooth breakages could reveal something about past animal behaviour. When modern mammals bite into bone they occasionally break a tooth, especially if they are starving and trying to tear off every last piece of meat. Overall, harder times should therefore lead to increased chances of a tooth striking bone and the possibility of a break.

Dr Van Valkenburgh studied 36 living carnivores, ranging from weasels to tigers, to determine the frequency of tooth breakage. She then compared the modern data with the teeth in fossils of five carnivore species, including sabre-toothed tigers and dire wolves from the Pleistocene, an epoch that ran from 1.8m years ago to 10,000 years ago.

Tooth-breaking was much more common in the past, she reports in the *Biological Journal of the Linnean Society*. The average fracture frequency for the Pleistocene species she sampled came to 8% whereas for modern species it was only 2%. She was struck by the discovery that in grey wolves and coyotes, which were around in the Pleistocene, there is a large difference between modern and fossil teeth. Breakage rates for grey wolves and coyotes are 4% and 5% respectively today; in the Pleistocene they were 10% and 7%.

The data strongly suggest that times were a lot harder for predators before humans dominated the planet. That is surprising considering the environmental pressure that most carnivorous mammals live under today. Dr Van Valkenburgh suggests one possibility is that the density and diversity of carnivores were higher in the past. People tend not to tolerate lots of large carnivores that can eat their livestock, pets, children and themselves, so they reduce predator numbers. In the past, with humans absent, more intense competition for food between carnivores probably led to a need to eat kills quickly and completely, resulting in more broken fangs.

Correction: Evolution

Feb 12th 2009
From The Economist print edition

In "Unfinished business", published on February 7th, we said in the United States a Gallup poll found that only 15% of people agreed with the proposition that "humans developed over millions of years", up from 8% in 1982. The figures should have been 14% and 9% respectively. This was corrected online.

The Richard Casement internship

Feb 12th 2009
From The Economist print edition

We invite applications for the 2009 Richard Casement internship. We are looking for a would-be journalist to spend three months of the summer working on the newspaper in London, writing about science and technology. Our aim is more to discover writing talent in a science student or scientist than a scientific aptitude in a budding journalist. Applicants should write a letter introducing themselves and an original article of about 600 words that they think would be suitable for publication in the science and technology section. They should be prepared to come for an interview in London or New York, at their own expense. A small stipend will be paid to the successful candidate. Applications must reach us by February 20th. They should be sent to: casement2009@economist.com.

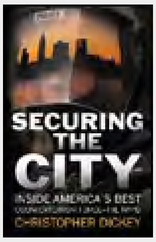
Counter-terrorism in America

NYPD's fighting force

Feb 12th 2009
From The Economist print edition

The NYPD offers an alternative to the highly militarised war on terror

Securing the City: Inside America's Best Counterterror Force—the NYPD
By Christopher Dickey



Simon & Schuster; 336 pages; $26

Buy it at
Amazon.com
Amazon.co.uk

New York Times

IT IS not often that a city has its very own counter-terrorist force. But since the attacks of September 11th 2001, New York has felt uniquely vulnerable—and uniquely entitled to special protection. In a vivid and thought-provoking book about the years since the twin towers collapsed, Christopher Dickey analyses how the New York Police Department (NYPD) counter-terrorism division has made itself one of the best in the business.

This did not happen easily or without resistance. The NYPD's commissioner, Ray Kelly, a former marine,

and his intelligence chief, David Cohen, who had worked for the CIA, faced considerable opposition in building their team. The principal aim was to use human intelligence to prevent future attacks. To achieve that they had to gather accurate and detailed information about al-Qaeda and other groups, and learn from the attacks they launched overseas. Never mind that this irritated the FBI and the CIA—the “three-letter guys”, as Mr Dickey calls them—who tended to regard the NYPD as some kind of Johnny-come-lately muscling in on their turf.

Mr Dickey ends up admiring Mr Kelly and Mr Cohen for creating a counter-terror organisation which many now regard as among the most energetic. They fought for and won the right to station people overseas—in London, Tel Aviv and as far off as Singapore—to provide first-hand information-gathering from useful places. And their most important achievement, in Mr Dickey’s estimation, is to have turned New York’s multicultural diversity to their advantage, building up a team of more than 600 linguists fluent in some 50 languages and dialects. In 2007 NYPD analysts published a 90-page booklet, “Radicalization in the West”, seeking to pass on what they had learnt about the home-grown threat in Europe and America.

A scheme to attack a busy New York subway station was foiled just two days before the Republican convention in 2004 when, thanks to an informant, Mr Kelly was able to arrest the Muslim plotters. The group was clearly incompetent but, as Mr Dickey points out, motley conspirators could be dangerous, “even when some were morons”.

“Securing the City” is a gritty, down-to-earth work; a very American book about a very American city. Mr Dickey accompanies cops on the beat, rides in their helicopters and describes in detail their gizmos and their crime labs. He delights in a tough-guy language that owes as much to Mickey Spillane as to Raymond Chandler. So the general reader can enjoy a book that has the pace and drama of a thriller, and for the specialist interested in questions such as how to defend a city of nearly 8.5m people, or what turns young Muslims into suicide-bombers, there is much to ponder.

As the Middle East editor of *Newsweek*, Mr Dickey is not only one of America’s most knowledgeable commentators on the area, he was writing about Osama bin Laden for almost a decade before the attacks on the twin towers. He adds fascinating new detail and asks some troubling questions. What was learnt from waterboarding senior al-Qaeda captives such as Abu Zubaydah and Khalid Sheikh Mohammad? Where do you draw the line between protecting security and abusing human rights? What do we know now about the Madrid and London bombings—and the important question of whether the bombers acted alone or with help from al-Qaeda? Whereas the Spanish attacks seem to have been home-grown, the evidence suggests to Mr Dickey that the leader of the London bombers, Mohammad Sidique Khan, was “an active al-Qaeda recruiter”.

The book shifts constantly from the local to the global and back. It is sharply critical of “the dangerously ill-conceived, mismanaged, and highly militarised ‘global war on terror’,” and sees the success of the NYPD’s counter-terrorism programme as offering an alternative approach. Mr Dickey worries about the depth of Muslim anger which drives the violence, and to which America has been largely oblivious. But he also draws comfort from the resilience of New Yorkers, whose faith in the American dream may well turn out to be their strongest line of defence.

Securing the City: Inside America’s Best Counterterror Force—the NYPD.
By Christopher Dickey.
Simon & Schuster; 336 pages; $26

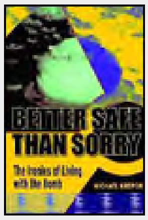
Living with the bomb

Better safe than sorry

Feb 12th 2009
From The Economist print edition

THE world is not going to hell in a handcart. Things are not worse than they were 25 years ago. In many ways, in fact, they are measurably better. There is hope that the foundations and load-bearing structures of global stability, though damaged, can be restored.

Better Safe Than Sorry: The Ironies of Living with the Bomb
By Michael Krepon



Stanford University Press; 296 pages; $29.95

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The first nuclear age was dominated by superpower confrontation, mutually assured destruction, periodic missile gaps and other nuclear panics; the second lives in the shadow of potential nuclear terrorism, the dangerous ambitions of North Korea, Iran and others, and yet more nuclear doom-mongering. In his latest work, “Better Safe Than Sorry”, Michael Krepon, one of America’s most sensible specialists in nuclear-risk reduction, argues that, however difficult the problems today, what helped keep the world safer first time round can do so again.

The big irony of the “better safe than sorry” first nuclear age was that the endless search for safety in numbers led America and the Soviet Union between them to build enough nuclear weapons (a combined total of 125,000) to make the rubble bounce from here to eternity. And yet, after Hiroshima and Nagasaki, the taboo against nuclear use has held.

Dumb luck played its part. The Russians covered up their mishaps, but America also had its fair share: a plane carrying hydrogen bombs breaking up in the air over North Carolina, another engulfed in flames for three hours on a runway in North Dakota, and so on. But human wisdom triumphed too. American presidents vetoed their generals’ nuclear strike plans. The unsung hero of the 1962 Cuban missile crisis was a Russian submarine officer whose lonely veto prevented the blind firing of his boat’s nuclear weapons as all contact with the outside world was lost.

Mr Krepon picks out five principles from the cold war that can still apply in lesser but still dangerous circumstances today: deterrence (an irrational set of theories that, ironically, grew out of attempts to think seriously about the bomb); conventional military strength; containment; diplomatic engagement; and, one useful result of all of the above, a readiness on both sides to engage in arms control. An equal achievement was the durability of the nuclear non-proliferation regime: most governments took the rational decision in seemingly irrational times that nuclear abstinence was the safest route to security.

It was the combination that counted: a lesson forgotten after the September 11th 2001 attacks, when George Bush sought America’s safety at first, not in diplomacy, containment and the judicious use of preventive strikes, but in military dominance and a disdain for diplomacy as a strategy. It was this new sort of “better safe than sorry” approach, whatever intelligence mistakes were made over Saddam Hussein’s weapons of mass destruction, that led Mr Bush to launch the world’s first preventive war for non-proliferation.

America’s new president is ready to re-engage on arms control, argue for still more radical weapons cuts and make “zero” the guiding thought of his nuclear policy. But Mr Krepon, a radical but no dove, counsels caution: zero may yet prove a better guide for the journey than a destination. Disarmament, like nuclear abstinence in the first nuclear age, has to be a rational calculation, not an act of faith; impatience can be the enemy of radicalism. Much, he argues, will depend on how those five key principles are now applied to Iran, whose nuclear ambitions are the greatest challenge to stability in the second nuclear age.

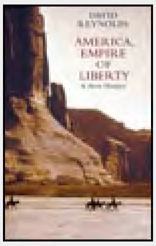
Better Safe Than Sorry: The Ironies of Living with the Bomb.
By Michael Krepon.
Stanford University Press; 296 pages; $29.95

American history

Freedom's messy triumph

Feb 12th 2009
From The Economist print edition

America, Empire of Liberty: A New History
By David Reynolds



Allen Lane; 704 pages; £30. To be published in America by Basic Books in May 2010.

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AFP

Soon to be the norm

WHICH American president was described by his top general as "nothing more than a well-meaning baboon"? Abraham Lincoln, who thought no better of General George McClellan. Convinced that a vast Confederate army lay in wait for him, McClellan hesitated to march on Richmond, Virginia, the rebel capital. "If General McClellan does not want to use the army, I would like to borrow it for a time," sighed Lincoln. When McClellan at last started creeping towards Richmond, he was embarrassed to discover that some of the imposing gun emplacements that had scared him were only painted logs.

David Reynolds, a Cambridge don, has written a one-volume history of the United States, from the mound-builders of the 11th century to the challenges facing President Barack Obama. With so much

ground to cover, the pace is inevitably frenetic, and the book includes little material that one could not find elsewhere. Lincoln’s sigh, quoted above, is a bit of an old chestnut. But it tells us something about the great president’s character. In the same way, Mr Reynolds’s book provides an entertaining and fair-minded introduction to American history.

One of his main themes is the discord between lofty American ideals and mucky American reality. In an early draft of the Declaration of Independence, for example, Thomas Jefferson accused King George III of waging “cruel war against human nature itself” by allowing the slave trade. “This was strange stuff, coming from a Virginian slave owner,” deadpans Mr Reynolds. He also captures the messiness of American history rather well. Texans celebrate the heroes, such as Davy Crockett, who fought for independence from Mexico. One of the freedoms they craved was the freedom not to be Catholic. Another was the freedom to own slaves. Texas was an independent country for a while—its old embassy in London is now a wine shop near the head office of *The Economist*. Back in Washington, Congress was slow to accept Texas into the Union because it feared reopening the question of whether new states should be slave ones or not, “thereby upsetting the delicate balance between North and South in the Senate”.

Mr Reynolds rejects the notion of American exceptionalism. The United States is an empire, assembled by conquest, much like any other, he argues, although Americans’ distaste for acquiring overseas territories has, for the most part, prevented it from colonising other nations. This point tends to be taken for granted by Americans and disbelieved by others. George Bush, for example, was genuinely surprised that so many Iraqis assumed he was planning to occupy their country for ever. His vice-president had hoped to start pulling out within a month of toppling Saddam Hussein.

This book is weakest when grappling with current events. In discussing the recent housing boom and bust, Mr Reynolds inexplicably fails to mention Fannie Mae and Freddie Mac, the government-backed lenders that did so much to inflate the bubble. And his lament about campaign costs—that the need to raise lots of money makes it hard for outsiders to compete for high office—sounds odd given Mr Obama’s swift ascent from nowhere.

Mr Reynolds’s analysis of America’s racial struggles, in particular, is fair and nuanced. As a historian, he sees how far the country has come. Where others see “angry fragmentation” today, he sees an “American miracle”, a country that has held together better than any other of comparable size or diversity. By 2050, he notes, whites will be a minority. But by then, the great divide between white and non-white “will have become meaningless because of inter-mixing”. As someone else put it: “Obama is 2050.”

America, Empire of Liberty: A New History.
By David Reynolds.
Allen Lane; 704 pages; £30. To be published in America by Basic Books in May 2010.

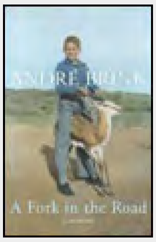
André Brink's memoir

For better or worse

Feb 12th 2009
From The Economist print edition

ANDRÉ BRINK, one of South Africa's best-known novelists, insists that his new book is not autobiography; it is a memoir. "A Fork in the Road" is one (white) Afrikaner's view of black South Africans' struggle for liberation. But it is also an account of Mr Brink's own internal struggle as he breaks away from his seemingly placid, conventional, Afrikaner childhood, "where apartheid was not a hateful idea but something that defined the parameters of the 'normal'"; through his rebellious years of starry-eyed liberalism and faith in the brotherhood of man; on to the wild euphoria that gripped Nelson Mandela's would-be "rainbow nation" in the 1990s; before ending with the "disillusionment, resentment, and rage tinged with despair" over the "rottenness" he feels is at the heart of the present regime.

A Fork in the Road: A Memoir
By André Brink



Harvill Secker; 448 pages; £17.99

Buy it at
Amazon.com
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Mr Brink has tried, almost desperately, he says, to give the ruling African National Congress (ANC) the benefit of the doubt. In a country that has undergone the massive upheaval and radical transformation that South Africa has experienced, it would, indeed, be unrealistic not to expect some measure of turbulence, he concedes. Only a fool could deny the distance travelled since Mr Mandela first walked free in 1990. "But one does reach a limit: where to remain silent becomes a culpable act. My time is over."

The tipping-point came when Mr Brink's own family was caught in the gratuitous "surplus of violence"—often between black and white, but also within ethnic groups—that he says has plagued the country for centuries. In 2006, as his daughter and her husband were dining out in a quiet restaurant in Somerset West, near Cape Town, five masked men burst in and forced the patrons to hand over their valuables at gunpoint, before herding them into a small storeroom. Nothing so unusual about that in today's South Africa. What outraged Mr Brink was the police's apparent lack of interest. No one had been killed, no one raped. It was a low priority.

At about the same time the minister of safety and security chose to launch a scathing attack on "whingeing" whites who constantly complain about violence, urging them to pack their bags and leave the country. Many have heeded his call. Last summer, after Mr Brink's nephew was shot dead by intruders at his home just north of Johannesburg in the presence of his wife and small daughter, friends urged him, too, to leave. Already in his 70s and newly married to his fifth wife, a young Austrian in her 20s, he may well have felt justified in contemplating such a move.

As he wrote after his nephew's death (too late, strangely, for inclusion in his book), there was a time, in the 1990s, when he felt he had enough faith in the ANC to want to stay and "be part of a tremendous historical transition towards freedom and justice." But that faith has been eroded. Mr Brink no longer believes that the levels of violence, racism, corruption, nepotism, racketeering, incompetence and injustice in today's South Africa will diminish any time soon. On the contrary, he sees "an endless proliferation of ills". And yet, he says, "I wish to stay." For it is this land, shared with others—black, brown and white—where his ancestors have been buried for nearly four centuries, that is his home, for better or worse.

A Fork in the Road: A Memoir.
By André Brink.
Harvill Secker; 448 pages; £17.99

New fiction: Abraham Verghese

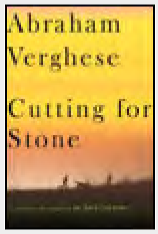
Under the knife

Feb 12th 2009
From The Economist print edition

SURGERY is a wonderful metaphor. Flexible and sharp, it can incise, expose, exenterate and heal. Abraham Verghese's first two books, "My Own Country" (1994) and "The Tennis Partner" (1999), were intelligent, sensitive examinations of health and disease, communication and loneliness; profound contemplations of the difficulty of life and the certainty of its loss. They brought him a wide following among readers of non-fiction, especially in America, where he now lives. Mr Verghese is an internal-medicine specialist, but his latest work, his first novel, suggests that he dreams of the free flight of fiction and perhaps, secretly, of surgical glory.

Illustration by Daniel Pudles

Cutting for Stone
By Abraham Verghese



Knopf; 560 pages; $26.95. To be published in Britain by Chatto & Windus in April; £17.99

Buy it at
Amazon.com
Amazon.co.uk

It is from the exotic highlands of childhood memory—Mr Verghese was born in Ethiopia of Indian parents—that the novel launches itself, plumaged in myth and magical realism. The protagonist—and his identical twin brother, his mother, his believed father and both his foster parents—are surgeons, or involved in the practice of surgery. They bicker, miscommunicate, fall in love and perform operations against a tapestry of cross-cultural desire, political change and colourful symptomatology at the sweetly named Missing Hospital on the edge of Addis Ababa. Further surgical spice is added in Madras, at an Eritrean field hospital and in New York. Surgery—dramatised, romanticised, mysticised—is the medium through which the tale is borne along, by which the characters find or lose each other, understand themselves, are rendered whole or apart.

At the novel's heart beats Mr Verghese's joy of medicine: his exultation in the poetry of its Latin phraseology, the arcane imagery based on resemblances between pathology and food. The names of surgery textbooks are introduced reverentially, like sacred scripts; he includes details of Ethiopian history, interesting surgical aphorisms, discourses on diseases and accounts of war-zone and trauma operating.

Patients figure primarily as the pulsus paradoxus or vesico-vaginal fistula that will provide some central character with his next epiphany. The novelistic drama perhaps excuses the odd clinical inexactitude, a sense of operative terms being applied with a somewhat whimsical notion of what they entail. "Cutting for Stone", a reference to an historic surgical procedure, as well as a pun on the protagonist's name, has the hybrid quality of a vivisectionist's experiment: a fleshy family saga stitched around a knobbly skeleton of surgical research. Surgery is indeed a wonderful metaphor, but it should be wielded with precision. The sort of precision so evident in Mr Verghese's earlier writings.

Cutting for Stone.
By Abraham Verghese.
Knopf; 560 pages; $26.95. To be published in Britain by Chatto & Windus in April; £17.99

Economist.com **BOOKS & ARTS**

Mongolia's bloody baron

Mad and bad

Feb 12th 2009
From The Economist print edition

A PSYCHOPATHIC Buddhist warrior-king hardly sounds plausible in fiction, let alone in modern history. But the story of Freiherr Roman Nikolai Maximilian von Ungern-Sternberg, an Estonian-raised, ethnically German, tsarist officer, who became the last khan of Mongolia amid the chaos of the Russian civil war, has so many bizarre elements that the reader will soon believe almost anything.

James Palmer's account of his brutal and ill-starred life is elegant, waspish and evocative. It starts in Estonia (then a Russian colony) where Ungern, as the author calls him, was born into a harsh family of Baltic Germans, the feudal masters of the region. Ungern was an obnoxious child; he tried to strangle a neighbour's pet owl and was expelled from school. His career in the Russian military gained him no distinction, only hideous scars, from duelling. He was almost uniformly detested.

As the "whites" (monarchists) lost the civil war, Ungern's star rose. Other leaders were dead or in exile. In 1920 Ungern and a ragged band of men struck south into Mongolia, hoping, ludicrously, to use it as a base to reconquer Russia and restore the Romanov *ancien régime* (though in fact the Romanov princeling he backed had long ago been murdered by the Bolsheviks).

Unlike some Russian nationalists, Ungern liked the Mongols, seeing them as the "scourge of God" to punish a sinful Russia. The "yellow race", he wrote, was "more vital and more capable of state-building" than the decadent whites. His beliefs were bolstered both by confused references to the more lurid bits of the Bible and by some firmly held but shakily understood Buddhist beliefs. He liked the ceremony and ritual of Buddhism, and particularly its respect for tradition: "its purity, the preservation of the old and correct order of things", as Mr Palmer puts it.

Ungern's religious tolerance did not extend to Jews, towards whom he nursed a fanatical loathing. During his 130-day rule of Mongolia, he ordered that "Commissars, Communists, and Jews, together with their families, must be exterminated."

Such personal savagery helped maintain a kind of discipline among his troops. Mr Palmer notes that he conquered a chunk of Mongolia through "sheer energy and desperation". But this was unmatched by any ability to command his forces intelligently or to seek allies elsewhere in the region. Within a few months Ungern was defeated by the advancing Red Army, betrayed, captured, tried and shot. The Mongolian escapade marked the peak of his career, but it was also a dismal failure.

Mr Palmer has done a good job in disentangling the myths and horror stories that surround his much-reviled subject. The result is a confident account marred by occasional flaws: a penchant for mixed metaphors plus some fanciful lapses and minor factual errors. His accounts of Ungern's bestial cruelty are not for the squeamish. The best bit of "Bloody White Baron" is the way it brings the repulsive combination of tsarist-era absolutism and mysticism to life. The Bolsheviks ultimately proved far worse. But it is easy to see why so many people thought that any change from monsters like Ungern could only be for the better.

The Bloody White Baron: The Extraordinary Story of the Russian Nobleman Who Became the Last Khan of Mongolia.
By James Palmer.
Basic Books; 288 pages; $26.95. Faber and Faber; £18.99

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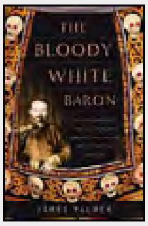


Basic Books; 288 pages; $26.95. Faber and Faber; £18.99

Economist.com BOOKS & ARTS

“The War of the Roses”

Cate and the king

Feb 12th 2009 | SYDNEY
From The Economist print edition

Queenly Cate Blanchett turns her attention to Richard II

Tim McKeough

Cate crowned

CATE BLANCHETT is known for the pale beauty of her face and her vivid film performances. Her latest work marks a significant change of pace. As the curtain rises at the Sydney Theatre, she sits centre-stage, a still figure in a white blouse and trousers, blond hair, high cheekbones. A storm of golden petals drifts down from the ceiling, and she wears a crown.

It has become fairly commonplace for film actors to star in London’s West End and on Broadway, but this transposition is different. Miss Blanchett is playing the king in Shakespeare’s “Richard II”, in the first part of a rigorously condensed version of the eight history plays. Miss Blanchett and her husband, Andrew Upton, have become artistic directors of the Sydney Theatre Company, an organisation which already has a fine opinion of itself. “In so far as there is a National Theatre in Australia, the Sydney Theatre Company is it,” says Rob Brookman, the general manager.

Sydney’s “The War of the Roses” ruthlessly cuts the histories down to two evening performances, each lasting a little under four hours, focusing on the death of kings and the hollowness of their crown. If this production, performed as part of the Sydney Festival and now on tour, is a clue to the nature of Miss Blanchett’s regime, it will be energetic, controversial, ambitious and, to use one of Miss Blanchett’s favourite adjectives, “noisy”. Casting her as Richard II was the bold idea of the director, the fearless 36-year-old Benedict Andrews. Having an actress play Richard II is not original; Fiona Shaw did it in London in 1995. But casting a woman as Richard III most certainly is. He is played by Pamela Rabe, one of Australia’s most accomplished actors, without a hump and with a heavy sense of irony, which provokes tense laughter in unlikely places.

Miss Rabe is not as self-consciously feminine as Miss Blanchett, who deploys laughter—her own—to dramatise the alienation of the king from his court, and fondly adopts girlish poses during the deposition scene when Richard passes the crown to Bolingbroke. Shakespearean actors need to drill their vocal chords and Miss Blanchett seemed a little short of training, but she made a likeable, vulnerable, androgynous monarch. Given the extent of the cuts and transpositions, there could be no lingering over the development of character. The playful relationship between Prince Hal (Ewen Leslie) and Falstaff (John Gaden), for example, was speedily established by Hal fellating Falstaff. Sydney was not fazed.

Many of Australia's best actors have emigrated in search of larger audiences and new writers. Miss Blanchett wants to bring in a younger audience to the Sydney Theatre Company's performances. "We're hoping to take a more joyous approach," Mr Upton said recently. Miss Blanchett and Mr Upton also want to develop the company's reputation abroad as well as at home. Later this year their production of Tennessee Williams's "A Streetcar Named Desire", directed by Liv Ullmann with Miss Blanchett as Blanche DuBois, travels to the Kennedy Centre in Washington, DC, and the Brooklyn Academy of Music. In this case of celebrity culture, the emphasis will be on the culture.

Rose Davis

Feb 12th 2009
From The Economist print edition

Rose Dean-Davis, campaigner and East End wife, died on January 31st, aged 67

Pennant Books

WHATEVER else she was, Rose Davis insisted she was not a gangster's moll. She knew a few of those. They liked the glamour of going out with a "face", the thrill of being in court, and didn't seem to mind a beating on a Saturday night. Her friend Jeannie Ishmail was one. Jeannie lived in a mobile home where nothing was out of place, and her girls were turned out immaculate; but her husband Mickey was a flash individual from Canning Town, a wheeler-dealer in various wide schemes, and she was always wearing sunglasses to hide the black eyes he gave her.

Rose's own husband, George, never hit her. He wouldn't have dared. The wedding photos told their own story: Rose looking pert and joyous in a white half-circle hat, with a big coat hiding the bump because she'd fallen pregnant some months before, while George was in a bad suit twiddling his fingers, and with his eyes elsewhere. She was 17, he was 16. It was 1958. They had met after school in Hackney, sitting on the wall outside the off-licence where the kids used to hang about. She thought later that they might have been a little bit young. Her wedding ring was a wide one, but it was only nine carat, and her mother told her she would never have a day's good luck with such a ring. How right she was.

George never showed much eagerness for work. He preferred to hang around drinking with Mickey Ishmail. It was Rose who slaved in the Sussex Laundry and washed up in pubs, putting the money carefully into a tin from which George borrowed. She knew he did a bit of receiving. It didn't shock her hugely. Her mother, who had to bring up nine children, had also been "a "fiddler", foraging secondhand clothes and selling on things, like chipped figurines and bits of silver, picked up in jumble sales. Rose's brothers were "lairy" too, liked a drink, were apt to get in a fight. Whatever George was doing, Rose didn't ask, until he was arrested in May 1974 for an armed robbery in Ilford.

He was convicted on the basis of police identifications and sent down for 20 years. Rose saw the photos; they showed a man standing very like George, though wearing a flying helmet she knew he didn't possess. She thought he had been out that day delivering fish down Chancery Lane, though she never knew for sure. When George's friends decided to fight the conviction, unleashing perhaps the most startling campaign ever waged to get one man out of a British jail, she was unsure at first. Then she joined in with a will, and even pushed right to the front of things.

It wasn't just a matter of demonstrating with placards and wearing George Davis T-shirts, though she did all that, even spelling his name wrong sometimes, she was so tired. She blocked roads, including Whitehall. She sat chained in a van outside Scotland Yard all one Christmas, in 1974, while a friend blew

the lights on the Christmas tree in Trafalgar Square. Her friends dug up the pitch at Headingley, scuppering the Test Match against Australia, and painted “George Davis is Innocent OK” on railway bridges and derelict buildings and even across the M1. (All this, and she was still taking George his home-cooked dinners in prison, roast potatoes and gravy all the way to Brixton.) In the Law Courts and at other unrelated hearings she would suddenly bounce up, a petite, furious figure, and scream “You sentenced an innocent man!” before the clerks bundled her out.

Turning on a sixpence

Though she wasn’t political, and never intended to be, the whole campaign was an East End howl against years of dismissive treatment by judges and the police. Long-haired radicals packed her flat and smoked stuff there, but she didn’t want their middle-class support. If anyone had told her that her campaign was a template for most anti-government protests since, she would have been surprised. She just thought the devil was in her. She had always had a sharp sense of what wasn’t fair, such as being paid a pittance at the laundry. Now she found the courage to yell it out continually. And in May 1976 George’s conviction was overturned as unsafe.

It looked like a love story. But love, as she said, could turn on a sixpence. George was barely out before he started visiting a girl and then, back with Mickey, got himself into more trouble. At a bank robbery in Holloway in September 1977 he was found at the wheel of a red Ford Transit, the getaway van. Another stitch-up, he told her; “And I’m the Queen of Sheba,” she replied. The parcel she took him in the cells this time contained a lovely shirt cut into several pieces, and a pair of trousers with the crotch cut out. They got “the quickest divorce ever”, in six months, uncontested.

Sometimes, looking back on it in her book, “The Wars of Rosie”, she blamed bad luck. She had a thing with sevens: married on the 7th of June, George arrested again in 1977, her daughter Deana dead, of cancer, on the 7th of March. More often, she blamed herself. She had always earned the money, brought up two children and kept everything going, as women did. Perhaps, as a Taurus, she was too strong for George; she had never given him any responsibility. After his release, he had even less interest in working and more in crime. He was famous now, could walk into any pub and be recognised as a “flash bloke”, a face. And so she became the gangster’s wife she always said she would never be.

Economist.com MARKETS & DATA
WEEKLY INDICATORS

Overview

Feb 12th 2009
From The Economist print edition

America's unemployment rate jumped from 7.2% to 7.6% in January. Firms, excluding farms, cut 598,000 staff that month, after large culls in the previous two months. In **Canada** employers cut 129,000 jobs in January, more than in any single month during earlier downturns. Canada's jobless rate leapt from 6.6% to 7.2%. Unemployment in **Britain** rose from 5.9% to 6.3% in the three months to December.

Europe's **industrial slump** continued to deepen. Output in Germany fell by 12% in the year to December. Industrial production in France was 11.1% lower than a year earlier. Italy's output shrank by 14.3%. In Britain it dropped by 9.3%.

China's exports fell by 17.5% in January compared with a year earlier and imports fell by 43.1%, signalling a deepening malaise in the world's third-largest economy.

Spain's GDP shrank by 1% in the fourth quarter compared with the previous quarter, its worst performance in more than 15 years. **Russia's** GDP rose by 1.1% in the year to the fourth quarter, a sharp slowdown from the rate of 6.2% in the previous quarter.

Sweden's Riksbank lowered its benchmark interest rate from 2% to 1% on February 11th, and said it may cut it further in the coming months. It expects Sweden's economy to shrink by 1.6% this year.

The Bank of Korea cut its benchmark interest rate to 2%, a record low, to aid the plunging **South Korean** economy.

Output, prices and jobs

Feb 12th 2009
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2008†	2009†	latest	latest	year ago	2008†	rate‡, %
United States	−0.2 Q4	−3.8	+1.2	−2.0	−7.8 Dec	+0.1 Dec	+4.1	+3.8	7.6 Jan
Japan	−0.5 Q3	−1.8	−0.2	−3.2	−20.6 Dec	+0.4 Dec	+0.7	+1.4	4.4 Dec
China	+6.8 Q4	na	+9.0	+6.0	+5.7 Dec	+1.0 Jan	+7.1	+5.9	9.0 2008
Britain	−1.8 Q4	−5.9	+0.7	−2.6	−9.3 Dec	+3.1 Dec§	+2.1	+3.6	6.3 Dec††
Canada	+0.5 Q3	+1.3	+0.5	−0.7	−5.1 Nov	+1.2 Dec	+2.4	+2.4	7.2 Jan
Euro area	+0.6 Q3	−0.7	+0.8	−2.1	−7.7 Nov	+1.1 Jan	+3.2	+3.1	8.0 Dec
Austria	+1.5 Q3	+0.6	+1.4	−1.3	+0.7 Nov	+1.3 Dec	+3.6	+3.2	3.9 Dec
Belgium	+1.3 Q3	+0.4	+1.3	−1.3	−11.6 Nov	+2.3 Jan	+3.5	+4.5	11.1 Jan‡‡
France	+0.5 Q3	+0.5	+0.7	−1.7	−11.1 Dec	+1.0 Dec	+2.6	+2.8	8.1 Dec
Germany	+0.8 Q3	−2.1	+1.1	−2.5	−12.0 Dec	+0.9 Jan	+2.8	+2.6	7.8 Jan
Greece	+3.1 Q3	+2.0	+1.1	−1.8	−8.7 Dec	+1.8 Jan	+3.9	+4.1	7.4 Oct
Italy	−0.9 Q3	−2.1	−0.6	−2.3	−14.3 Dec	+1.6 Jan	+3.0	+3.3	6.7 Q3
Netherlands	+1.8 Q3	+0.1	+1.8	−1.6	−13.3 Dec	+1.9 Jan	+2.0	+2.3	3.9 Dec††
Spain	−0.7 Q4	−3.9	+1.1	−2.3	−15.4 Dec	+1.4 Dec	+4.2	+3.9	14.4 Dec
Czech Republic	+4.2 Q3	+3.8	+4.0	−1.4	−14.6 Dec	+2.2 Jan	+7.5	+6.3	6.8 Jan
Denmark	−1.2 Q3	−1.9	−0.6	−1.7	−5.4 Dec	+1.8 Jan	+2.9	+3.5	2.1 Dec
Hungary	+0.8 Q3	−0.3	+0.8	−3.0	−23.3 Dec	+3.5 Dec	+7.4	+6.2	8.0 Dec††
Norway	+0.6 Q3	−2.8	+1.8	−0.2	+3.7 Dec	+2.2 Jan	+3.7	+3.8	2.9 Nov***
Poland	+4.8 Q3	na	+5.1	+2.9	−4.4 Dec	+3.3 Dec	+4.0	+4.3	9.5 Dec‡‡
Russia	+1.1 Q4	na	+6.0	+1.0	−10.8 Dec	+13.4 Jan	+12.6	+14.1	7.7 Dec‡‡
Sweden	nil Q3	−0.4	+0.6	−1.0	−20.3 Dec	+0.9 Dec	+3.5	+3.4	6.4 Dec‡‡
Switzerland	+1.7 Q3	+0.1	+1.8	−1.0	+0.7 Q3	+0.1 Jan	+2.4	+2.3	2.9 Jan
Turkey	+0.5 Q3	na	+2.3	+0.4	−17.6 Dec	+9.5 Jan	+8.2	+10.5	10.3 Q3‡‡
Australia	+1.9 Q3	+0.3	+2.2	+0.3	+3.8 Q3	+3.7 Q4	+3.0	+4.4	4.8 Jan
Hong Kong	+1.7 Q3	−2.0	+3.0	−3.0	−6.7 Q3	+2.1 Dec	+3.8	+4.2	4.1 Dec††
India	+7.6 Q3	na	+5.3	+5.0	+2.4 Nov	+9.7 Dec	+5.5	+8.2	6.8 2008
Indonesia	+6.1 Q3	na	+6.1	+3.5	+1.9 Nov	+9.2 Jan	+5.6	+10.4	8.4 Aug
Malaysia	+4.7 Q3	na	+5.1	−0.3	−15.6 Dec	+4.4 Dec	+2.4	+5.5	3.1 Q3
Pakistan	+5.8 2008**	na	+6.0	+1.2	−1.2 Nov	+20.5 Jan	+11.9	+20.3	5.6 2007
Singapore	−3.7 Q4	−16.9	+1.2	−7.2	−13.5 Dec	+4.3 Dec	+4.4	+6.5	2.6 Q4
South Korea	−3.4 Q4	−20.8	+4.1	−2.8	−18.6 Dec	+3.7 Jan	+3.9	+4.9	3.3 Jan
Taiwan	−1.0 Q3	na	+1.8	−3.5	−32.3 Dec	+1.6 Jan	+2.9	+3.5	5.0 Dec
Thailand	+4.0 Q3	+2.3	+3.4	−1.0	−18.8 Dec	−0.4 Jan	+4.3	+5.5	1.1 Sep
Argentina	+6.2 Q3	+5.4	+5.5	−1.8	−7.2 Nov	+6.8 Jan	+8.2	+8.6	7.3 Q4‡‡
Brazil	+6.8 Q3	+7.4	+5.3	+1.6	−14.5 Dec	+5.8 Jan	+4.6	+5.7	6.8 Dec‡‡
Chile	+4.8 Q3	−0.2	+3.5	+1.0	−3.7 Dec	+6.3 Jan	+7.5	+8.7	7.5 Dec††‡‡
Colombia	+3.1 Q3	+2.9	+2.7	−0.5	−13.3 Nov	+7.2 Jan	+6.0	+7.0	10.8 Nov‡‡
Mexico	+1.6 Q3	+2.6	+1.8	−1.4	−5.4 Nov	+6.3 Jan	+3.7	+5.1	4.3 Dec‡‡
Venezuela	+4.6 Q3	na	+4.9	−3.0	+2.7 Sep	+30.7 Jan	+24.1	+30.4	6.3 Q4‡‡
Egypt	+5.9 Q3	na	+7.2	+4.9	+7.3 Q3	+14.4 Jan	+10.5	+18.3	8.6 Q3‡‡
Israel	+5.1 Q3	+2.3	+4.1	+0.9	+0.3 Nov	+3.8 Dec	+3.4	+4.5	5.9 Q3
Saudi Arabia	+3.5 2007	na	+4.2	+0.4	na	+9.5 Nov	+4.8	+9.4	na
South Africa	+2.9 Q3	+0.2	+3.0	+1.0	−7.0 Dec	+9.5 Dec	+9.0	+11.3	23.2 Sep‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	−3.5 Q3	na	−2.8	−5.0	−20.7 Dec	+4.1 Jan	+11.0	+10.4	8.3 Nov
Finland	+1.3 Q3	+0.4	+1.6	−1.3	−15.6 Dec	+3.5 Dec	+2.6	+4.1	6.6 Dec
Iceland	−0.8 Q3	−5.5	−0.5	−9.7	+0.4 2007	+18.6 Jan	+5.8	+13.8	4.8 Dec‡‡
Ireland	+0.1 Q3	+4.7	−2.9	−4.0	−12.3 Dec	+1.1 Dec	+4.7	+4.2	9.2 Jan
Latvia	−10.5 Q4	na	−1.8	−8.0	−14.2 Dec	+9.8 Jan	+15.8	+15.4	9.0 Nov
Lithuania	−1.5 Q4	−9.3	+3.7	−4.8	na	+8.5 Dec	+8.1	+10.9	7.0 Jan‡‡
Luxembourg	−0.3 Q3	−5.5	+0.6	−2.8	−9.8 Oct	+1.1 Dec	+3.4	+3.4	5.0 Dec‡‡
New Zealand	−1.4 Q3	−2.7	−0.9	−1.9	−0.5 Q3	+3.4 Q4	+3.2	+4.3	4.6 Q4
Peru	+5.1 Nov	na	+9.1	+3.1	+5.1 Nov	+6.5 Jan	+4.2	+5.8	8.1 Dec‡‡
Philippines	+4.5 Q4	+4.1	+4.3	−0.5	−6.6 Nov	+7.1 Jan	+4.9	+9.3	6.8 Q4‡‡
Portugal	+0.6 Q3	−0.5	+0.3	−2.0	−11.4 Dec	+0.8 Dec	+2.7	+2.6	7.7 Q3‡‡
Slovakia	+7.0 Q3	na	+6.8	+2.0	−16.7 Dec	+3.7 Jan	+3.8	+4.6	8.4 Dec‡‡
Slovenia	+3.8 Q3	na	+4.0	+0.5	−17.5 Dec	+1.6 Jan	+6.4	+5.7	6.7 Nov‡‡

*% change on previous quarter, annual rate. †*The Economist* poll or Economist Intelligence Unit estimate/forecast. ‡National definitions.- §RPI inflation rate 0.9% in Dec. **Year ending June. ††Latest three months. ‡‡Not seasonally adjusted. ***Centred 3-month average

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

The Economist commodity-price index

Feb 12th 2009
From The Economist print edition

The Economist commodity-price index

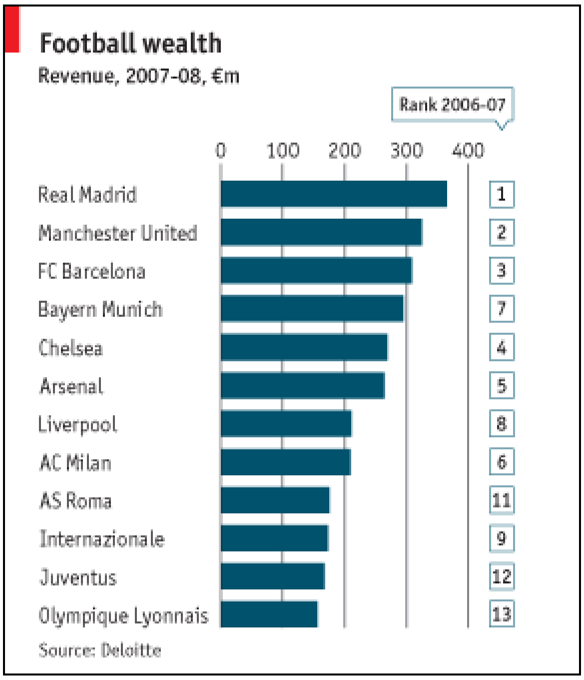
2000=100

	Feb 3rd	Feb 10th*	% change on one month	% change on one year
Dollar index				
All items	157.6	161.3	+2.7	-32.5
Food	186.4	190.0	+2.8	-21.4
Industrials				
All	120.3	124.3	+2.7	-47.3
Nfa†	114.1	114.9	+1.6	-38.2
Metals	123.6	129.4	+3.2	-50.8
Sterling index				
All items	166.5	166.6	+1.8	-9.8
Euro index				
All items	112.4	114.4	+3.8	-24.2
Gold				
$ per oz	906.80	912.70	+10.9	+2.5
West Texas Intermediate				
$ per barrel	41.04	37.87	-1.6	-57.1

*Provisional †Non-food agriculturals.

Football wealth

Feb 12th 2009
From The Economist print edition



Manchester United may be champions of Europe on the football pitch, but Real Madrid remains top of Deloitte's annual Football Money League. For a fourth consecutive year, the Spanish club was the biggest revenue earner in world football. But its continued dominance of the Money League owed as much to swings in currencies as to on-field brilliance. The 21% increase in United's revenues in 2007/08 ought to have been enough to claim top spot. But once the club's sterling income was translated into euros, it fell short of Madrid's €366m. The slump in the pound (rather than a rogue refereeing decision) robbed United of a third title, to go with the UEFA Champions League and English Premier League.

Trade, exchange rates, budget balances and interest rates

Feb 12th 2009
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance* latest 12 months, $bn	Current-account balance latest 12 months, $bn	Current-account balance % of GDP 2008†	Currency units, per $ Feb 11th	Currency units, per $ year ago	Budget balance % of GDP 2008†	Interest rates, % 3-month latest	Interest rates, % 10-year gov't bonds, latest
United States	−820.6 Dec	−697.9 Q3	−4.6	–	–	−3.2	0.42	2.76
Japan	+36.2 Dec	+156.0 Dec	+3.6	90.3	108	−3.1	0.61	1.30
China	+314.8 Jan	+371.8 2007	+10.2	6.83	7.20	−0.1	1.31	3.25
Britain	−173.0 Dec	−45.6 Q3	−2.2	0.70	0.51	−5.3	2.15	3.61
Canada	+45.8 Dec	+19.2 Q3	+1.0	1.25	1.00	0.3	0.72	2.94
Euro area	−52.0 Nov	−88.9 Nov	−0.4	0.78	0.69	−1.7	2.00	3.34
Austria	−1.5 Nov	+16.8 Q3	+3.1	0.78	0.69	−0.9	1.99	4.11
Belgium	+5.6 Nov	−8.2 Sep	+0.4	0.78	0.69	−0.9	2.02	4.18
France	−79.6 Dec	−56.1 Dec	−1.8	0.78	0.69	−3.2	1.99	3.65
Germany	+264.5 Dec	+237.0 Dec	+6.6	0.78	0.69	0.2	1.99	3.19
Greece	−67.0 Nov	−52.6 Nov	−13.3	0.78	0.69	−3.9	1.99	5.63
Italy	−18.7 Nov	−72.4 Nov	−2.8	0.78	0.69	−2.8	1.99	4.37
Netherlands	+55.4 Nov	+67.6 Q3	+6.9	0.78	0.69	1.0	1.99	3.78
Spain	−149.5 Oct	−164.1 Oct	−9.8	0.78	0.69	−3.3	1.99	4.04
Czech Republic	+4.4 Dec	−6.6 Dec	−3.1	22.1	17.5	−1.5	2.44	4.42
Denmark	+5.6 Dec	+6.0 Dec	+1.0	5.78	5.12	3.3	4.50	3.91
Hungary	nil Dec	−11.3 Q3	−5.6	229	180	−3.4	9.49	9.80
Norway	+78.9 Dec	+86.5 Q3	+18.4	6.77	5.48	19.7	3.70	3.95
Poland	−24.0 Nov	−29.4 Nov	−5.6	3.54	2.47	−1.8	4.70	5.62
Russia	+179.8 Dec	+98.9 Q4	+6.0	35.2	24.7	5.5	13.00	12.29
Sweden	+17.2 Dec	+40.5 Q3	+7.3	8.38	6.42	2.6	0.78	2.99
Switzerland	+18.4 Dec	+40.3 Q3	+8.9	1.16	1.11	0.9	0.50	2.02
Turkey	−69.8 Dec	−41.4 Dec	−6.0	1.64	1.20	−1.5	13.88	7.61‡
Australia	−4.0 Dec	−56.7 Q3	−5.0	1.53	1.12	−0.3	3.18	4.25
Hong Kong	−26.0 Dec	+27.1 Q3	+10.0	7.75	7.80	−1.2	0.78	1.57
India	−114.5 Dec	−28.5 Q3	−3.6	48.7	39.8	−6.0	4.82	7.01
Indonesia	+8.7 Dec	+3.9 Q3	+0.4	11,760	9,260	−1.4	9.91	10.11‡
Malaysia	+42.7 Dec	+38.3 Q3	+11.4	3.60	3.24	−5.1	2.59	4.02‡
Pakistan	−20.9 Jan	−15.6 Q3	−5.5	79.4	62.9	−6.8	13.96	23.86‡
Singapore	+18.4 Dec	+29.2 Q3	+13.5	1.51	1.42	0.8	0.59	1.90
South Korea	−12.2 Jan	−6.4 Dec	−2.1	1,393	946	1.7	2.91	5.26
Taiwan	+6.2 Jan	+28.8 Q3	+4.7	34.0	31.6	−1.7	1.10	1.52
Thailand	+0.2 Dec	−0.2 Dec	−0.3	35.1	32.9	−1.4	2.20	2.78
Argentina	+13.2 Dec	+9.0 Q3	+2.7	3.49	3.16	0.2	14.69	na
Brazil	+23.3 Jan	−28.3 Dec	−1.9	2.27	1.75	−0.7	12.66	6.16‡
Chile	+8.5 Jan	−1.6 Q3	−2.5	601	467	4.5	6.36	3.90‡
Colombia	+2.0 Dec	−5.3 Q3	−2.7	2,543	1,900	−1.4	9.43	7.17‡
Mexico	−16.0 Dec	−11.8 Q3	−1.9	14.5	10.8	nil	7.07	8.28
Venezuela	+50.2 Q3	+49.4 Q3	+14.8	5.60	5.25§	−1.1	17.14	6.55‡
Egypt	−25.2 Q3	+0.1 Q3	−0.9	5.55	5.51	−6.8	11.46	4.76‡
Israel	−13.7 Dec	+2.6 Q3	+0.7	4.06	3.61	−1.2	0.66	3.36
Saudi Arabia	+150.8 2007	+95.0 2007	+26.2	3.75	3.75	33.6	1.15	na
South Africa	−10.9 Dec	−23.2 Q3	−7.5	9.88	7.72	0.1	10.05	8.21
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*								
Estonia	−3.9 Nov	−2.5 Nov	−9.6	12.1	10.7	−2.3	6.73	na
Finland	+10.2 Nov	+6.8 Nov	+3.5	0.78	0.69	4.6	1.96	3.64
Iceland	−0.2 Jan	−5.4 Q3	−17.3	114	67.3	0.3	18.22	na
Ireland	+41.4 Nov	−16.4 Q3	−4.9	0.78	0.69	−6.6	1.99	5.15
Latvia	−6.4 Dec	−4.8 Nov	−14.1	0.55	0.48	−2.7	8.76	na
Lithuania	−7.4 Dec	−6.4 Nov	−12.6	2.68	2.37	−1.0	7.20	na
Luxembourg	−7.8 Nov	+4.0 Q3	na	0.78	0.69	−0.1	1.99	na
New Zealand	−3.8 Dec	−11.6 Q3	−9.0	1.91	1.28	−1.0	3.75	4.43
Peru	+3.2 Dec	−3.0 Q3	−3.8	3.24	2.90	2.1	6.30	na
Philippines	−7.5 Nov	+2.9 Sep	+1.8	47.1	41.0	−0.8	5.31	na
Portugal	−34.4 Nov	−29.3 Nov	−11.5	0.78	0.69	−2.4	1.99	4.39
Slovakia	−0.9 Dec	−6.4 Oct	−6.1	23.4	22.6	−2.3	1.35	3.90
Slovenia	−4.7 Dec	−3.1 Nov	−6.1	0.78	0.69	−0.6	1.99	na

*Merchandise trade only. †*The Economist* poll or Economist Intelligence Unit forecast. ‡Dollar-denominated bonds. §Unofficial exchange rate.
Sources: National statistics offices and central banks; Thomson Datastream; Reuters; JPMorgan; Bank Leumi le-Israel; Centre for Monitoring Indian Economy; Danske Bank; Hong Kong Monetary Authority; Standard Bank Group; UBS; Westpac.

Markets

Feb 12th 2009
From The Economist print edition

Markets

	Index Feb 11th	% change on: one week	Dec 31st 2007: in local currency	Dec 31st 2007: in $ terms
United States (DJIA)	7,939.5	-0.2	-40.1	-40.1
United States (S&P 500)	833.7	+0.2	-43.2	-43.2
United States (NAScomp)	1,530.5	+1.0	-42.3	-42.3
Japan (Nikkei 225)	7,945.9	-1.2	-48.1	-35.8
Japan (Topix)	778.1	-1.9	-47.3	-34.8
China (SSEA)	2,373.4	+7.3	-57.0	-54.1
China (SSEB, $ terms)	143.7	+9.8	-63.3	-60.7
Britain (FTSE 100)	4,234.3	+0.1	-34.4	-52.7
Canada (S&P TSX)	8,737.9	+0.5	-36.8	-50.1
Euro area (FTSE Euro 100)	695.5	-0.9	-49.4	-55.4
Euro area (DJ STOXX 50)	2,267.9	-1.3	-48.5	-54.5
Austria (ATX)	1,712.4	-1.5	-62.1	-66.5
Belgium (Bel 20)	1,884.0	-1.2	-54.4	-59.7
France (CAC 40)	3,027.7	-1.3	-46.1	-52.4
Germany (DAX)*	4,530.1	+0.8	-43.8	-50.4
Greece (Athex Comp)	1,744.5	nil	-66.3	-70.3
Italy (S&P/MIB)	18,074.0	+0.3	-53.1	-58.6
Netherlands (AEX)	253.3	-0.6	-50.9	-56.7
Spain (Madrid SE)	885.2	-1.8	-46.1	-52.4
Czech Republic (PX)	740.4	-1.2	-59.2	-66.5
Denmark (OMXCB)	238.6	-1.9	-46.8	-53.1
Hungary (BUX)	11,737.5	-1.3	-55.3	-66.3
Norway (OSEAX)	284.5	+4.0	-50.1	-59.9
Poland (WIG)	24,124.1	+3.8	-56.6	-69.9
Russia (RTS, $ terms)	620.6	+20.5	-61.2	-72.9
Sweden (Aff.Gen)	202.2	+4.9	-40.6	-54.2
Switzerland (SMI)	5,123.8	-1.9	-39.6	-41.1
Turkey (ISE)	25,398.4	-2.8	-54.3	-67.3
Australia (All Ord.)	3,418.1	+1.1	-46.8	-60.2
Hong Kong (Hang Seng)	13,539.2	+3.6	-51.3	-51.0
India (BSE)	9,618.5	+4.5	-52.6	-61.6
Indonesia (JSX)	1,324.8	+0.3	-51.8	-61.5
Malaysia (KLSE)	897.1	+2.3	-37.9	-43.0
Pakistan (KSE)	5,429.4	-1.9	-61.4	-70.1
Singapore (STI)	1,722.0	+0.9	-50.3	-52.5
South Korea (KOSPI)	1,190.2	-0.4	-37.3	-57.8
Taiwan (TWI)	4,576.0	+4.2	-46.2	-48.7
Thailand (SET)	444.1	+2.6	-48.2	-50.3
Argentina (MERV)	1,108.0	+2.7	-48.5	-53.5
Brazil (BVSP)	40,845.0	+1.8	-36.1	-49.9
Chile (IGPA)	12,482.4	+1.5	-11.3	-26.5
Colombia (IGBC)	8,022.2	+1.9	-25.0	-40.5
Mexico (IPC)	19,446.7	-0.9	-34.2	-50.5
Venezuela (IBC)	35,140.9	-1.6	-7.3	-58.8
Egypt (Case 30)	3,546.0	-0.1	-66.1	-66.3
Israel (TA-100)	627.5	+1.5	-45.6	-48.4
Saudi Arabia (Tadawul)	4,847.6	+1.1	-56.1	-56.1
South Africa (JSE AS)	21,054.5	+2.0	-27.3	-49.7
Europe (FTSEurofirst 300)	803.4	-1.0	-46.7	-52.9
World, dev'd (MSCI)	845.0	-0.3	-46.8	-46.8
Emerging markets (MSCI)	553.5	+3.3	-55.6	-55.6
World, all (MSCI)	210.3	nil	-47.8	-47.8
World bonds (Citigroup)	779.5	+0.4	+6.7	+6.7
EMBI+ (JPMorgan)	388.5	-0.3	-10.4	-10.4
Hedge funds (HFRX)‡	1,033.5	+0.2	-22.3	-22.3
Volatility, US (VIX)	44.5	43.9	22.5	(levels)
CDSs, Eur (iTRAXX)†	147.7	-5.0	+191.9	+157.6
CDSs, N Am (CDX)†	215.4	-1.9	+176.5	+176.5
Carbon trading (EU ETS) €	8.5	-19.0	-62.8	-67.2

*Total return index. †Credit-default swap spreads, basis points.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CMIE; Danske Bank; EEX; HKMA; Markit; Standard Bank Group; UBS; Westpac. ‡Feb 10th

Hedge funds

Feb 12th 2009
From The Economist print edition

The growth of the hedge-fund industry came to a halt in 2008, as assets under management fell by almost a quarter and the number of funds shrunk by almost a tenth. This was the first big setback since Hedge Fund Research started keeping data on the industry back in 1990, when funds under management were just $39 billion. Clients were promised that the industry offered “absolute” (or positive) returns, but the average fund lost nearly a fifth of its value last year; they were also told that hedge-fund returns were not correlated with the equity market: they were in 2008. Early signs from 2009 are that the industry posted an average 0.4% gain in January. Even so, faith in hedge funds has been shaken.